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IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

Part 1

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IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

WEDNESDAY, JANUARY 9, 1985

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Nashville, TN.

The committee met, pursuant to notice, at 9:33 a.m., in room 30, Legislative Plaza, State Legislative Office, Nashville, TN, Hon. James R. Sasser (acting chairman of the committee) presiding.

Present: Senator Sasser.

Staff present: Tom Walsh, tax counsel; Lawrence G. Dalsin, professional staff member; and Stewart J. Hudson, professional staff member.

STATEMENT OF HON. JAMES R. SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator SASSER. The committee will come to order. I would like to open these remarks this morning by welcoming all of these witnesses and thanking you very much for taking time off from your schedules to be here with us today. From my days in the law practice, when I represented some small businesses, I know how valuable time is for small business people, so I greatly appreciate your efforts to come here and be with us this morning for these hearings.

I have a more extensive statement prepared which will be submitted for the hearing record, but my primary interest is in the remarks of these witnesses on a most important subject.

The Senate Small Business Committee will be conducting a series of field hearings all across the United States, exploring the impact of the proposed new tax reform proposals on small business. These hearings were requested by the chairman, Senator Lowell Weicker of Connecticut, in conjunction with the ranking minority member of the Small Business Committee, Senator Bumpers of Arkansas, and this hearing here in Tennessee marks the first step in this process. Frankly, I am pleased that we are able to have the leadoff hearings here in Tennessee where small business is central, I think, to the economic well-being of this State. There are some 83,000 business establishments here in Tennessee, and of these 79,000 have less than 100 employees, and are defined as small businesses by the State. Some 58,000 of these businesses employ fewer than 10 people. These small firms produced roughly one-half of Tennessee's $50 billion in goods and services in 1982. Small business makes up 99 percent of the construction firms in the State of

Tennessee. Small business makes up 98 percent of the service operations; 99 percent of the finance, insurance, and real estate businesses. Over 80 percent of our manufacturing concerns and 61 percent of the State's retail and wholesale operations qualify as small business. So in reality, small business is very big business here in Tennessee.

Now, these small firms share in the growing interest in tax reform that's spreading across the country, and I think small business has much to add to the debate on this issue. Many of you here today would agree that our present tax system is too complex, too inefficient, and full of loopholes. You also would likely contend that small business pays more than its fair share of Federal taxes; and if you do contend that, you are not alone. Over 41 percent of the respondents in a recent tax survey responded by saying that small business pays too much in taxes. Over two-thirds of those surveyed said that large companies pay less than their fair share of Federal income taxes. There is a good reason for this point of view. The Joint Economic Committee of the Congress issued a report late in 1984 showing that the corporate share of the Federal tax burden was 6.2 percent in 1983. That's down from 17 percent in 1970. Individual tax returns, on the other hand, accounted for 48 percent of all the Federal receipts.

Now, the new Treasury Department proposal which we read about in the newspapers and the now former Secretary of the Treasury, Mr. Donald Regan—has been pushing, will be the focus of today's hearings. We're going to hear more and more in the coming weeks and months about the Treasury Department proposal, as we attempt to balance the tax burden a little more evenly.

While I think we ought to applaud all efforts to restore a greater sense of equity to our tax system, we must make sure that we know in advance the full impact of tax reform proposals before implementing such programs. And I think this is especially important in the small business community.

To date, there has been almost no dialog on the consequences of the Treasury Department tax reform proposal on small business. No one has addressed what changes in effective tax rates would mean to small firms. No one has talked about how changing the investment tax credit and depreciation rules, among other subjects, will affect small business.

Given the economic importance of small business, this is a glaring omission which must be rectified. These hearings are the first step in the process of exploring the impact of tax reform proposals on small business. This underscores the importance that myself and the Senate Small Business Committee attach to the remarks of these witnesses who will appear here today. The comments that we will hear today will provide the Senate Small Business Committee with a record upon which we can speak out in behalf of small business in the coming debates in the Finance Committee and on the floor of the U.S. Senate, dealing with tax reform.

Well, with that said, let me thank all these distinguished small business people for taking time out from their schedules to be with us today, and we can go forward here and proceed now with the first panel.

[The prepared statement of Senator Sasser follows:]

STATEMENT OF HON. JAMES R. SASSER, A U.S. SENATOR FROM THE STATE OF TENNESSEE

As Congress reconvenes for its 99th session, one of the major issues looming on the legislative horizon is tax reform. Many Americans are of the mind that our present tax system is too complex, inefficient and riddled with abusive loopholes. Several proposals have already been submitted which would reform and arguably simplify our existing tax structure. Secretary of Treasury Donal Regan has submitted his recommendations for a modified flat tax to the President. In addition, many of my colleagues have introduced legislation of their own drastically overhauling our tax code.

The Treasury Department proposal is the focus of our hearings today. This proposal has garnered much public attention, in part because it incorporates many elements of other tax reform proposals such as the Bradley-Gephardt FAIR tax plan. The Treasury proposal makes sweeping changes in almost all sections of our tax structure. According to its authors, the Treasury proposal would scale back by nearly one-third the almost 280 million hours now spent by Americansin preparing tax returns. The plan would drastically alter individual taxes, scrapping the present 14 tax brackets for 3. On the corporate side, the statutory tax rate would be a flat 33% for all corporations. In addition, the Treasury plan increases personal exemptions while dropping many existing deductions and credits.

The net effect of the multitude of changes according to Treasury officials would be a 25% increase in corporate taxes in the next fiscal year, bringing in $22 billion more than companies would pay under current law. By 1990, this would increase to a

36% increase. Individuals on the other hand would enjoy an average 8.5% cut in tax liabilities.

Despite all the preparation which went into the Treasury Department proposal, I am very troubled by the fact that little, if any, attention has been paid to the small business consequences of this and other tax reform proposals. While many of us support the idea of tax reform, we want to know how the different proposals will impact important segments of the economy. To that end, it is imperative that those of us on the Senate Small Business Committee become actively involved in the debate on tax reform. Today's hearings mark the first step in this process.

I am proud that we have launched this series of field hearings in Tennessee, where small business plays a central role in the state's economic well-being. Of the nearly 83,000 business establishments in Tennessee, 79,000 employ less than 100 persons. In fact, over 58,000 have less than 10 employees. In 1982, these small firms produced roughly half of Tennessee's $50 billion in goods and services. Moreover, small firms constitute 99% of our construction companies, 98% of our service operations, 99% of the finance, insurance and real estate trade and 80% of Tennessee's manufacturing companies. As you can see, small business means big business for Tennessee.

These small firms share in the growing interest in tax reform and have much to add to the debate on this subject. Many of the witnesses before us today will argue that small business pays more than its fair share of Federal taxes. Public opinion supports them in this position. Over 41% of the respondents in a recent survey on taxes said small business pays too much in taxes. Over two-thirds of the respondents in this same survey said that large companies pay less than their fair share of Federal income taxes.

There is good cause for this perception. The Joint Economic Committee issued a report late in 1984 showing that the corporate share of the Federal tax burden was only 6.2% in 1983, down from 17% in 1970. Individual tax returns accounted for 48% of all Federal receipts. Indeed, many industry groups were able to use the tax code to lower their effective rates far below the statutory 46% level. Eleven industry groups had effective rates below 10% in 1983.

Much in the Treasury Department proposal is aimed at restoring a greater sense of equity to our tax system, and I applaud that motive. Yet, I want to know more about where the small business person fits into this picture. It is critical that we know the full impact of tax reform proposals on small business before rushing to implement such a program. To date, there has been little to no dialogue on the consequences of tax reform for small business. No one has addressed what changes in tax rates, the investment tax credit, and depreciation rules among other subjects will mean to small firms.

This glaring ommission will be rectified through the record we begin to construct today. The comments and remarks heard by the Small Business Committee will lay a firm foundation from which we can speak out in behalf of small business in upcoming debates on tax reform.

Senator SASSER. Our first witness is Bill Nourse, who really needs no introduction. Bill has been very active in the field of small business for a number of years. He is a successful small businessman himself, and he is appearing before this committee today in a new role as the president of the American Independent Business Network. And accompanying Mr. Nourse is Prof. Jeff Schoenblum. Professor Schoenblum is a professor of law at Vanderbilt University; he is considered an authority on tax matters, and we're delighted to have him here with us today.

Mr. Nourse, if you would lead off, please.

STATEMENT OF BILL NOURSE, BROOKMEADE HARDWARE, AND PRESIDENT, AMERICAN INDEPENDENT BUSINESS NETWORK

Mr. NOURSE. Senator, thank you very much. I do indeed share your pleasure in that the Small Business Committee's first hearing is in Nashville. As a member of the Senate Small Business Committee's advisory council, I do share your deep commitment that the Small Business Committee does play a crucial role and will play a very crucial role in the tax reform process.

I feel very strongly that this process of going to the grassroots first is something unique in my 5 years of experience with the Senate Small Business Committee and the Congress of the United States. I can't think of a single issue that affects small business where the process of hearings has gone to the grassroots first before you've listened to the institutionalized representations for small business in Washington. I think that's important for several reasons, but the first and most important in my mind is the fact that it avails you the opportunity to hear directly from small business people, the actual practitioners in the private sector, of how these things are going to affect them.

But there's a double side to this important concept, and that is that the small business people, the small business community all across this country, understand the significance of the opportunity to participate in this debate. And I think that is the most significant part of these hearings, that we are now being able to participate at the Washington level in this crucial issue of tax reform. And if there's anything that I have a sense of in the last 1½ years or so of going to and from Washington, it is that there is real potential for tax reform this year. I think that the budget reduction process that we are about to engage in will lead ultimately to tax reform; I think the sequence of things that are about to happen will lead rapidly to a serious discussion of tax reform. I think the tax reform will be a serious part of the overall scheme of things in 1985, and I do really appreciate the role that the committee is going to play in this.

I think, as we move forward in this debate, we need to recognize that the issues that small business really is concerned with, besides the specifics of the proposals, would be first the fairness issue. And I think, in my travels across this country, there is a real perception today in the small business community that the fairness issue is something that has to be dealt with. There is a wide disparity in this country between those who pay and those who don't; the rates of those that pay, and those that pay low rates. As an example, the joint committee from the House issued a report in November of 1984 that clearly demonstrated that such industries as tobacco and trucking and pharmaceuticals and computers and office manufacturing pay very high effective rates, as high as 33 percent, and 38 percent in some cases. Yet, at the same time, it is clear that railroads and chemicals and the financial institutions, construction, motor vehicle manufacturing, and the telecommunications industry pay a very low effective tax rate. And yes, you're right, it also points out that small business pays a very high and disproportionate rate of taxation.

So I think that we really need to examine the fairness issue in this process.

Simplification is another term that I've heard used very widely; and I know in my own case, I would like to see the tax laws of this country simplified so that the average small business person can understand what he's doing, not need a tax consultant and a lawyer to do every bit of his tax planning and his tax work.

But in addition to those two points, I would like to add a third point, and I'm sure you are going to hear more about it today, and that is the word "stability". We have had 4 years of tax changes—probably more like 7, when we consider some of the bills before the 1981 bill—and it's reached the point where the small business community, as well as the business community at large, no longer can make adequate plans because they're not sure what they start out with in the way of a business plan in January or February will be what they're dealing with from a taxation standpoint by August or September. And 1984 was a good example of that; a lot of changes in the 1984 bill were retroactive to January. One of those, Senator, affects something that you and I have a deep and abiding interest in, direct expensing. We started out in 1984, in January, assuming that we could have direct expensing at one level; and later on in the middle of the year, with the Treasury proposals and changes, we didn't have it. We were back to what we had the year before. And I think it's this kind of thing that we have got to work toward eliminating.

While we engage in this debate and take part in this dialog, we've got to keep in mind who creates the jobs in this country, who creates the innovation. It is well documented that the small business community is the prime source of these things; and yet, when we look at Treasury's proposals, there is a total lack of understanding of the job-creating mechanism. There's nothing in those proposals that gets at the role that small business plays. There is no vehicle for stimulating job creation. We need to examine how ITC's are affected. I, for one, as a small business owner, take advantage of ITC's quite regularly. It is an incentive to modernize and keep up my equipment, et cetera, so I would be very concerned about the loss of ITC's. When it comes to ACR's, I'm not sure; we'll have to listen to the broader small business community and what their views are. But I do share the view that ACR's are one vehicle that large business uses quite effectively to avoid taxation. And again, the point I mentioned earlier, I'm very concerned that direct expensing is lacking in Treasury's proposal. It is quite apparent they're trying to put a cap on it. They don't even include it in their proposed items for being indexed.

And last, of the items that concern me greatly, the concept of a flat rate. In principle it sounds very attractive; but in reality, for those of us that are small business that are incorporated, you're really talking about a dramatic rate increase. For most small business companies my size, our profits are well under $100,000 a year. Under Treasury's proposal some of us could have a tax increase as large as 120 percent.

So I think we need to examine the concept and understand its true impact on small business, and think about maybe a tiered approach to it. Some of us who were a part of the 10-year-long fight to gain a tiered approach to corporate tax rates really have to think twice before we'll say we'll support in general, in total, a flat rate. I think it needs to be some kind of a tiered approach.

So in conclusion I would like to say that I think there's a unique opportunity for small business. The issues are complex; they are far-reaching, and many of them are very direct in their impact on small business. But knowing that, I don't want to leave the impression that we should shirk from the debate or step aside and allow the issues to be settled by big business. For the first time, we have an opportunity to participate in the debate. We need to recognize that, and we need to join forces with the Senate Small Business Committee and be a direct part of that process.

Senator, thank you.

Senator **Sasser**. Well, thank you very much, Bill Nourse, and I'll have a question or two for you in a moment, but we'll hear now from Professor Schoenblum.

STATEMENT OF JEFFREY A. SCHOENBLUM, PROFESSOR OF LAW, VANDERBILT UNIVERSITY SCHOOL OF LAW

Mr. **Schoenblum**. Thank you, Senator Sasser, for inviting me to testify in connection with this very important topic, this very important debate that is going on, and in particular, the concern that has been expressed with respect to the small business community.

There has been a lot of talk about simplification, economic neutrality in the tax proposal, and these are very worthy objectives; however, I think we should keep in mind, and get down to the details, that the objectives sought may not in fact be accomplished. And after making a few points about simplification and economic neutrality, I would like to apply the tax—the Treasury study—to the particulars of small business activity.

With respect to simplification, as worthy as that objective is, it seems to me under the Treasury study that we will have a problem because to a large degree, the current law with respect to income items will remain in effect. So we will still have the old system, the old, complex system that has been in effect for many decades now. On top of that we will have laid over it certain new concepts, certain interesting but quite complicated concepts—indexing, RCRS, some of the other items involving interest, expensing, limitations on expensing, and the capital gains elimination, the point that corporations now will be taxed at a flat rate—in effect what we have is not only a new layer of taxation on top of an old layer of taxation, but we're putting those who have the least ability to acquire expert tax advice, can afford it least, in a position of having to make new and complicated business decisions.

What's more, as has been pointed out here already, we have the problem of effective dates. The experience of the 1984 Tax Reform Act indicates there was a lot of controversy in that respect, many different dates. What you have is a patchwork of the old law, the new law; this, in effect, will once again complicate, not simply. So again, while in theory it is very fine to pursue simplification—I think that's what we all desire—I'm not so certain that in light of what we already have, that that is readily accomplishable.

The other concern that I have is if we hold up too great expectations about simplification, and then we don't come through with simplification, this may actually further discredit the tax system. What I'm suggesting then is not that we don't seek to simplify or to alleviate the burden on small business, but rather we focus our attention on particulars rather than sell it as a broad panacea for all the tax ills that we have.

The other point that comes out of the Treasury study is this business about economic neutrality, the idea that it is almost inappropriate to concern ourselves with the effect that tax law will have on particular industries. It seems to me that right now we have a pretty good mix of direct revenue grants by the Government and indirect benefits accorded through the tax system. It's true that there are many abuses, but on the other hand there are certain circumstances in which the tax benefit is more efficient in terms of being rewarded to an industry or a business activity than setting up a new Government agency or creating a bureaucracy to administer direct relief or grants or whatever. It seems to me that mix, again, is very desirable, and the Treasury proposal suggests that no such concerns should be had. This is particularly relevant with respect to small business because small business seems, to me, to play an extremely important role in the economic vitality of this country, and we must keep that in mind. We can't just enact broad-brush provisions that don't take into account the consequences for this very important segment of our society.

Now, with respect to the particulars, I find a mixed bag when you talk about the effect of the Treasury study proposals on small business. I think the proposals, to a large degree, could be devastating on capital-intensive businesses, particularly those requiring investments in machinery, real estate, and the like. The reason I say that, you can take a few examples here; depreciation, for instance. I've seen a few studies. The RCRS, real cost recovery system that's being proposed, is actually not as beneficial in many cases as ACRS or, even as is suggested here by Bill, the straight line depreciation, useful life, real useful life approach that has been pretty standard in the past. So in that sense, you're removing one of the benefits that currently is available. Take the elimination of investment tax credit. Again, this is a very important incentive for investment in capital by a number of small businesses and yields an immediate result and, in fact, is particularly beneficial to small businesses that aren't or haven't been in as high a tax bracket under the current progressive—somewhat progressive—rate of corporate taxation which may now go out the window.

Another point, capital gains; again, you have a problem as far as that goes. If you eliminate capital gains, the studies that I've seen show various results, but it complicates the decisionmaking process. It's very likely that in a number of instances, even though now all tax rates will be the same— ordinary income and capital gains, and the ordinary income rates would be lowered—the cost with respect to the elimination of capital gains could be substantial, specifically for businesses that have capital assets or investors who deal in capital assets.

The interest indexing—I'm somewhat concerned about that because the traditional method of financing for small business has been borrowing. Now, it seems to me by gearing the interest deduction to inflation, which you're going to do; while—theoretically it's very defensible, and actually desirable—what you do is, you raise the cost of borrowing because the deduction will not be worth as much, because you only get a deduction for the real cost. This is fine if it shifts investment to equity, but the problem is, in the meantime what's going to happen to the small business that may not be able to get that equity up front and meantime is going to have to go out there and borrow at additional cost? And when you couple that with the depreciation elimination or revision, the ITC elimination, you have a problem. The same thing with expensing, which you have played such an important role in.

This expensing for business property, I think, is a very valuable provision; and yet, look at the Treasury proposal. What it does is freeze that expense at the $5,000 limit; no indexing, as was pointed out, in this case. And so what you have is a progressive repeal of this provision as inflation proceeds. This, again, is another negative I see in all of this.

Finally, I would have to chime in on this business about the rates. For a lot of businesses, it is true, as for a lot of individuals; the rate of taxation, the effective rate, will be brought down. But for small businesses, for many small businesses, businesses earning, let's say, under $100,000 a year, under $125,000 a year income, the rate of taxation will actually go up; not only the actual rate, but when you combine it with the elimination of certain other tax benefits, you are increasing or multiplying that effect, and I think this could have a very strong negative impact on small business.

Just to conclude, I don't mean to suggest that all of the provisions proposed by the Treasury are undesirable with respect to small business. I do think, for instance, some of the changes—such as the deduction that is provided for dividends paid—will unleash equity that is now retained in larger corporations and may make available, eventually, such funding for smaller businesses. I think the shift that is taking place clearly from capital-intensive to service and retail small businesses is, to a certain degree, one that is justified and is long overdue, but it should be done in a reasonable manner and not at the cost of destroying capital-intensive industry. I also think there is a general shift away from the bias that has existed in favor of existing, operating larger companies, for instance, that have benefitted most by the up-front deductions that have been available, so this should favor somewhat small, start-up companies, and so forth.

But overall, again, I think that we have a basic problem here. There is some good potential in this study; what you have to do, it seems to me, is ferret through all of that, take out the good stuff, leave out some of the bad, moderate some of the suggestions somewhat, and then you may come up with a real advance in tax law.

Thank you very much.

Senator SASSER. Well, thank you, Professor Schoenblum, and that's the purpose of these hearings, to find out what the good stuff is and what the bad stuff is, and hopefully accentuate the positive and eliminate the negative.

Professor Schoenblum has a lengthy prepared statement which we will, without objection, incorporate in the record.

Mr. SCHOENBLUM. Thank you.

Senator SASSER. It occurs to me—can our people in the back of the room hear the witnesses? We don't have any microphones here. Can you hear them all right? Good.

Bill Nourse, in 1980 you were a delegate to the White House Conference on Small Business, and that White House conference listed direct expensing which you and Professor Schoenblum have referred to as a No. 2 priority item. You and I worked together, along with a number of other Tennessee small businessmen, and were able to enact direct expensing into law. Many people didn't think we could, including, as I recall, a number of business organizations in Washington, the U.S. Chamber and the NFIB and a number of others, but we got it done anyway. My question to you, is there still support for direct expensing out there in the small business community?

Mr. NOURSE. Absolutely. It's widely used, and I think the fact that it's widely used is indicated by Treasury's effort to cap it. I think it's an extremely useful tool.

Senator SASSER. Well, do most small businesses use direct expensing, or do they rely on depreciation rules such as accelerated cost recovery assistance?

Mr. NOURSE. Well, my sense of it is that direct expensing is very widely used; and then, some of them that are capital intensive probably use ACR's also. But my sense of direct expensing is that we ought to continue to fight to expand it to larger numbers. I think that it's going to be a real struggle to save it at the $10,000 level at this point, which is where the 1981 bill went. I think that Professor Schoenblum has clearly demonstrated that the effect of the changes that they're talking about not only puts a cap on it but, over a period of time, makes it insignificant. And I think that we need to get it back to the $10,000 level or even beyond that, not only because it's a useful tool and it's a good vehicle to help build capital within the small business itself, but it's a strong element of simplification for the really small business.

Senator SASSER. I take it from your remarks that you oppose the so-called flat tax system as it affects a small business, but you would not—at least on the surface—categorically oppose a so-called tiered approach incorporated in a flat tax system. Is that a fair statement?

Mr. NOURSE. That's a very accurate statement of my view at this point. I don't think that small business has much to benefit from the proposed 33-percent flat rate at all; in fact, we lose in that deal.

I think that some kind of a tiered approach to this process is what we need. A lot of changes that we have fought for over the years will be undone by this change.

Senator SASSER. Have you had an opportunity to think through how this tiered approach might work and give us some suggestions here today? Or, if not, would you do that and give us some suggestions for the future?

Mr. NOURSE. Sure. I think a basis to start with would be a tiered approach at the corporate rate that's existing right now, up to the first $100,000 or $125,000. But I certainly will incorporate that in my finished written statement.

Senator SASSER. Thank you.

Professor Schoenblum, do you believe that the "ability to pay" concept which theoretically underlies our progressive tax rate structure has any relevance with regard to corporate income?

Mr. SCHOENBLUM. Yes. I believe that the "ability to pay" consideration or concern is one that should pervade the tax system generally as long as it is a real concept; and in that sense, I think the proposal, the attempt here, to get to real effective rates on ability to pay is fine. The three tiers, for instance, on the individual side are fine; on the corporate side, again, I would echo the comments that were just made. I believe we should have some sort of graduated system because, again, small businesses are not in the position necessarily to pay at the same rate as the more profitable and larger corporations. I would suggest, as one possibility, if you're trying to have economic neutrality, why not gear the corporate rates in a graduated structure much like the individual rates?

In other words, you have those three levels; so thereby, there would not be any great incentive, for instance, to use the corporate form or any other form, the individual or partnership form. And yet, you would take account of the fact that those who conduct their operations for nontax reasons in the corporate form would get the same treatment as they would under this proposal if they conducted their activities in the individual or partnership form. So why should the corporate—the small corporation—be penalized, whereas we have recognized that there should be graduated rates, even under the Treasury study, with respect to individuals.

Senator SASSER. You know, you made an interesting statement. You took the position that the Treasury Department is saying that we shouldn't concern ourselves about how the tax structure would affect the individual industries or segments of an industry. Interestingly enough, our trading adversaries, the Japanese, take just the opposite view. They are very much concerned about how Government policy, including taxing policy, impacts on various industries, and they use that as a means, as you know, to encourage the so-called up and coming industries and to get the so-called rising star or rising sun industries going, and use it also as a way to discourage those industries that they perceive to be losers. And that way they use the tax structure to some extent almost as an industrial policy.

Mr. SCHOENBLUM. Senator Sasser, I couldn't agree with you more. I think it's important to note that the tax system is only one facet of the entire economic picture; and whether you support industry through tax subsidy of some sort, tax benefits, or whether you provide direct grants or whether you enact some kind of restraints on trade or protection against foreign imports, what it all boils down to is the same thing. Some ways may be more efficient than others. But I think it can lead to some unfortunate results if we fail to realize that we are in a worldwide economic network and that we must analyze the impact of these provisions in terms of our vital industries.

Senator **Sasser**. One final question. The general view of the investment tax credit is that it favors capital-intensive industries over labor-intensive industries, and favors profitable large firms over fast-growing or startup companies. Now, given these perceptions—and I assume that they are accurate—one would think that small business makes little use of the investment tax credit. Is that the case, or does small business use investment tax credit?

Mr. **Schoenblum**. Well, I have to defer to my colleague here who is in small business—I just teach it—but let me say, it is my impression that this would be certainly a valuable tool for a number of small businesses, operating small businesses. I think it is correct to say that startup businesses that really don't have any tax liability would not be able to make use of investment tax credit, although I think you could structure it in such a way that if these were desirable activities, you could have a more generous carryover, carry-forward system whereby you could save up investment tax credits and then apply it later on as you got on your feet and you were starting to earn more income and could use more credit. But certainly for operating small business, I think this is a very vital provision and has proved quite useful for such businesses. I think it's more beneficial, of course, than the depreciation deductions, especially under the new system, because with the rates falling the depreciation deduction won't be worth as much for those in the lower bracket or 33-percent rate or whatever, whereas investment tax credit is dollar-for-dollar benefit.

Senator **Sasser**. Well, gentlemen, thank you very much. I could ask you a lot more questions but we have a number of other witnesses to testify here today and, as you know, our time is limited.

I might say that we're going to leave the record open for 3 weeks if you wish to make additional written addendum to what you've said today. And thank you very much for giving us the benefit of your views.

Mr. **Nourse**. Thank you, Senator.

Mr. **Schoenblum**. Thank you.

[The prepared statement of Mr. Schoenblum follows:]

STATEMENT BY
JEFFREY A. SCHOENBLUM
PROFESSOR, VANDERBILT UNIVERSITY
SCHOOL OF LAW
NASHVILLE, TENNESSEE
BEFORE SENATE SMALL BUSINESS COMMITTEE
JANUARY 9, 1985

Let me begin by expressing my appreciation for the opportunity to testify before the Committee on this very important topic of tax reform. Specifically, I have been asked to comment on the Treasury Department Study Proposals [hereinafter referred to as TDSP]. Although I would like to reserve the right to add more extensive remarks into the record, for purposes of this relatively brief testimony I plan to outline my key points, both in terms of the general philosophy of the TDSP and the impact of certain particular items on small business. While I do find several positive elements in the TDSP, I believe this, as well as other, reform proposals currently on the table are seriously misguided.

I. General Critique of the TDSP

There seem to be two preeminent themes underlying the TDSP: simplification of the Code and the enactment of tax laws that are economically neutral in the sense that they do not create indirect incentives with respect to certain economic activity.

A. Simplification.

With respect to the much-publicized simplification point, I have the following criticisms:

1. Simplification is not necessarily an appropriate objective in an increasingly complex economic environment. As transactions and economic relationships increase in complexity and have national and worldwide ramifications, a precise, detailed Code and accompanying regulations may prove more helpful and contribute a greater degree of predictability and stability than a nonspecific, simplified tax law.

2. The circumstances of particular industries and their respective roles in the larger economic picture change over time. Simplification tends to emphasize the broad-brush approach and thereby may fail to take account of certain nuances that a highly sophisticated, but comprehensible, tax law would not ignore.

3. The TDSP, in particular, will not simplify the tax laws. There are a number of reasons for this.

a. The TDSP retains most of the current structure with respect to items of income. The numerous controversies and interpretive problems that have arisen in the past with respect to such items will continue. In light of the foreclosure of other avenues of tax avoidance, controversy over such items may actually intensify.

b. In addition to the complex pre-existing structure that would remain, the TDSP actually introduces several major new concepts that will contribute to complexity. These include the RCRS depreciation method, the indexation of interest to inflation, and the indexation of basis for capital gains purposes. Inevitably, interpretive questions will arise and regulations will have to be promulgated. On a more pragmatic level, business people and their advisors will have to become accustomed to the new rules. Moreover, these are not simply a few technical amendments. We are dealing here with wholesale change. Sweeping changes will not only necessitate an intensive short-term education process but may also precipitate dramatic alterations as well in long-term business planning. In other words, while the tax law may be "simplified," the conduct of business may be substantially complicated.

c. During a transitional period of several years there will be two tax laws in effect. For example, properties acquired before a certain date would still be subject to ACRS or the pre-1982 methods of depreciation.

d. A related difficulty concerns effective dates. Recent experience with the Tax Reform Act of 1984 demonstrates the potential for controversy in deciding when provisions become effective. A variety of effective dates under a new law would essentially mean the piecemeal, staggered effectuation of tax reform and leave for some time a confused patchwork of old and new statutory provisions.

4. Even if simplification were desirable and technically attainable, the political process almost certainly guarantees that it will not be achieved.

a. Historically, the tax legislative process has been one of constant revision, compromise and addition in which the views of important constituencies are taken into account and incorporated into legislation. This is entirely proper, but it works counter to the kind of broad-brush, theoretically pure, result sought by the TDSP.

b. Consistent with this historical experience, Treasury Secretary Regan has already suggested a willingness to consider revamping the RCRS depreciation method. President Reagan recently indicated that those urging elimination of the deduction for state and local taxes had a substantial burden of persuasion to overcome. These sorts of public comment will tend to invigorate those seeking to chip away at the TDSP. The problem with the TDSP is that once some concessions are made there is really no reason not to make others. Once simplification, or for that matter, fairness and economic neutrality have been compromised, the motive force behind the entire effort dissipates.

c. The TDSP itself is not true to its stated objectives. For example, home mortgage interest remains deductible, but state and local taxes are not deductible. There is little justification for this result in terms of simplification, fairness, or economic neutrality. Thus, the question could be raised during the legislative process: If we are going to inject economic and social considerations into tax law by preserving the home mortgage interest deduction or, for that matter, the investment tax credit for research and development, why not also retain the state and local tax deduction, another tax benefit for which a rational defense can be advanced?

d. The TDSP is revenue neutral; it is not designed as a means to raise additional funds for the government. In light of the prevailing concern over deficits, one could argue that this is an inappropriate time to be considering a plan that offers no short-term practical benefit, that could create serious economic and social dislocations, and that diverts attention from the more immediate concern over deficits. Under these circumstances, it seems unlikely and certainly would be unwise for elected officials to expend political capital by working to eliminate the tax benefits currently available to just about every political constituency.

e. Even if a simplified system is enacted, strong pressure for incremental change is likely to be felt in future years as the exigencies of the economy as a whole or particular industries arise. There is an organic process by which tax law grows. If this is historically true, is it worth the expenditure of the effort now to achieve simplification? Much is made of the low opinion of the tax laws held by the general populace. Will it, or the reputations of the legislators, be enhanced if heightened expectations are soon dashed? Thus, it must be emphasized that one of the greatest potential costs associated with the TDSP, or the similar congressional alternatives, is that the whole tax legislative process and whatever law ultimately survives may be seriously delegitimized.

5. A strong case can be made that for most taxpayers the tax law is already quite simple. Few taxpayers itemize deductions and only an infintessimal number regularly claim benefits such as the long-term capital gains deduction or accelerated depreciation. Most taxpayers are salaried and subject to wage withholding. Those who are subject to the more complex provisions of the tax law represent a very small minority of all taxpayers. These persons are generally reasonably sophisticated and may actually prefer the predictability and familiarity of the current system over the TDSP. In short, simplification may be an appealing rallying cry in the abstract, but may really represent nothing more than a cause in search of a problem.

B. Economic neutrality and tax as a tool of economic and social policy.

At the heart of the Treasury Study proposals is the assumption that taxation should be as economically and socially neutral as possible. In my opinion, this assumption regarding the tax system is totally mistaken. Tax reform inevitably benefits some at the expense of others. Until now, Congress has approved allocation of revenues by direct subsidy and by indirect tax incentives. A great theoretical debate has been waged over whether indirect subsidy is the proper way for the government to function. My own view is that a good balance has been struck and that in some, though not all instances, indirect subsidy is far more appealing, if only because the administrative and bureaucratic costs associated with direct grants are avoided. My concern with the TDSP proposal is that it really does not acknowledge the existence of the debate. Thus the effect of the TDSP is to delegitimize the use of taxation as a tool of economic and social policy.

Of course, at the same time that the TDSP demands neutrality, it would seek the enactment of several provisions that would not further neutrality at all. For example, certain provisions can only be read as preferring homeowners and investors in research and experimentation. This is inconsistent with the underlying theory of the TDSP.

Additionally, it must be recognized that there are great risks in seeking neutrality at all costs. The changes in depreciation and investment credit may, in fact, hurt this country's ability to compete in industries vital to the nation's national defense. They may also create more immediate unemployment or propel workers into lower paying, less secure, nonunion service jobs. The changes in depreciation, accompanied by the new limits on the value of the interest deduction, the elimination of capital gains favorable rates, the application of "at risk" rules to real estate and the limits on tax exempt bonds could dampen the rehabililitation of the housing and office stock that is currently taking place, with vast economic and social consequences. The proposed elimination of tax free group insurance may lead employees to take benefits in cash, thus diminishing the pool of insured persons and driving up the cost of insurance for everybody. Finally, the elimination of the deduction for state and local taxes may not, in fact, simply eliminate the subsidy for rich people in high tax states. Instead, it may result in resistance to state tax increases in those states by the middle and upper classes, with the result that the needy in those states will make increasing demands on the federal government or alternatively raise the level of racial and class confrontation in society. A recent report suggests a major decline in charitable contributions might also result in triggering additional social costs.

One could go on and on. The point is not that making some dramatic changes would be improper. Rather, each proposed change should be approached carefully, its unique variables and risks analyzed, its interaction with other factors properly deciphered and a decision made after lengthy debate. The problem with the TDSP is that it lumps together all indirect tax subsidies, basically characterizes them as illegitimate, and fails to deal with the immense economic and social costs that will almost certainly be engendered in the short term and which may extend many years into the future.

The history of tax legislation and economic policymaking in general is that few ever accurately foresee all or even many of the ramifications. Surely, no one can predict the overall consequences of the Treasury's radical reform effort.

For example, who could say today whether the "real" interest deduction and the deduction for dividends paid proposed will shift investors to equities or whether the elimination of the reduced capital gains rates will shift them out of equities. Will the elimination of the six month holding period encourage irresponsible speculation in less worthy securities? No one can answer these questions, but they are all deserving of the kind of discussion and staff review that the traditional tax legislative process would afford. On the other hand, if "tax neutrality," as defined by the Treasury, is the test, such discussion and examination is irrelevant. In fact, it would threaten the consistency and coherence of the new system of tax being proposed.

II. The Effect of the TDSP on Small Business

The impact of the TDSP on small business is difficult to assess. Few sweeping generalizations can be drawn. However, certain conclusions seem fairly evident:

1. Capital-intensive business will suffer short-term and, possibly, long-term damage.

2. The tax rate for some small corporations may go up at the same time presently available tax benefits that cut the effective rate are being eliminated.

3. The introduction of certain new concepts such as RCRS, as well as indexation for inflation, will result in no real simplification for purposes of tax compliance.

4. These new concepts are likely to complicate business decisionmaking and place smaller companies at a competitive disadvantage vis-a-vis larger businesses.

5. Traditional forms of debt financing will become considerably less attractive.

On the positive side, the TDSP may do the following:

1. Unleash additional equity financing for deserving small businesses.

2. Remove the bias currently favoring capital-intensive business and help foster growth in the service and retail enterprises.

3. Make small, start-up companies more competitive with larger companies that will now be deprived of certain tax benefits.

4. Eliminate differentials in tax rates based on the type of entity utilized, thereby diminishing organizational and legal costs.

I will now proceed to analyze some of the specific provisions that could affect small business.

A. Depreciation.

The TDSP dramatically alters the current accelerated cost recovery system (ACRS) by replacing it with RCRS, that is, "real cost recovery system." RCRS differs from ACRS in a number of ways. First, the inflation-adjusted cost of a depreciable asset would be recoverable rather than its original nominal cost. Second, various types of property would be reassigned among seven recovery classes. Third, there would be an invariable recovery percentage per year. Finally, the percentage recovery per year would reflect the estimated decline in value per year.

The proposed RCRS system in and of itself has certain appealing attributes and has probably been unfairly condemned by those who have an especially high financial stake in preserving ACRS. The introduction of a true economic depreciation model is certainly desirable in the abstract and may actually be helpful in practice. For example, small businesses often lack significant earnings in their start-up and initial phases of operation. ACRS significantly front loads depreciation deductions and thus favors ongoing enterprises with sizeable profit. A steadier flow of cost recovery, shielded from the detrimental impact of inflation on the value of the depreciation deduction could be helpful to some small businesses.

In most other respects, however, the proposed RCRS system may prove undesirable. First, the recovery period can be unusually lengthy. For example, real estate is treated as having a useful life of 63 years. Furniture, fixtures and various types of equipment that formerly were recoverable over five years would be recoverable under the Treasury proposal over 17 years. Assuming a 5% rate of inflation and 4% rate of return, this would mean in the first five years of service of an asset costing $1,000, that only $481 would be recovered under RCRS rather than the entire $1,000. Factoring inflation in, the present value of the RCRS deductions over 17 years would be $781 while under 5 year straight line depreciation it would be $810 and under ACRS $837.

Interestingly, at a 10% rate of inflation the present value of deductions is greater under RCRS than under either straight-line or ACRS depreciation. However, it is unlikely that a 10% rate of inflation would be acceptable in this country over a sustained period and the 5% figure does seem more realistic. Moreover, many operating businesses do have a substantial interest in recovering major capital outlays upfront. This may be particularly important for small enterprises that do not have the capital reserves of larger companies. In this regard, the negative impact on a small business may be compounded by another proposed change — the indexation of the interest deduction. The effect will be to increase the cost of borrowing to finance the acquisition of capital assets.

The small businessman or woman does not typically employ a battery of economists and financial advisors to make projections regarding national economic behavior over several years. Yet, under RCRS, effective business planning will require such projections. The higher the inflation rate, the more beneficial RCRS will be and thus the more beneficial it will be to make capital investments. The small businessman will find himself in a less competitive position to make these vital decisions. Futhermore, circumstances will alter year to year with changing economic conditions. The element of predictability, which is so critical to businesses operating on slight margins, will be lost. In my opinion, a significant disincentive will have been created for small businessmen and investors to participate in capital intensive enterprises.

This last point is of critical importance. Because of the new risks to capital-oriented enterprise introduced by RCRS, as well as other provisions, a shift in small business to service and retail activities could be accelerated. A recent Wharton School study even suggests that consumption will be encouraged by RCRS, thereby having a dampening effect on GNP, which in turn will put in jeopardy the small enterprises that are least secure financially.

If the TDSP changes are to be wrought, they should be analyzed in the context of broad national economic and social policy. Admittedly, there have been excessive benefits derived under ACRS by some taxpayers. Altering the recovery period for real estate from 15 to 18 years is one response to this. On the other hand, ACRS has been credited with stimulating a major capital investment in equipment that has driven the current economic recovery and has helped start the revitalization of industries long neglected.

Finally, there is little attempt by the TDSP to support the shift to RCRS on simplicity grounds. Indeed, changes are justified on the ground of economic neutrality, even at the cost of the introduction of complexity into the system. The small businessman might find himself depreciating assets under 3 systems: pre-1982, ACRS, and RCRS. Under RCRS, constant adjustments in basis would have to be made and the already-discussed projections as to inflation attempted. Novel bookkeeping and accounting problems could be created.

B. Investment tax credit.

Unquestionably, the investment tax credit has been abused for tax shelter purposes. The TDSP proposes its abolition. The abolition of the credit for certain types of investment is arguably a sound course. When coupled with the proposed shift to RCRS, however, it tends to exacerbate the problems already outlined above with respect to capital-intensive business.

Moreover, I believe creative solutions to ITC abuse can be devised. For example, the credit clearly favors established, highly profitable enterprises. Why not consider gearing the credit to smaller businesses making investments in certain types of equipment. The TDSP focus on research and experimentation is a good start in this direction. However, in its zeal to eliminate the credit's use in abusive tax shelter situations, it has come forth with a too restrictive, across-the-boards proposal that would intensify the burden on small businessmen who would also experience the loss of other tax benefits such as ACRS.

The TDSP recognizes the value of the credit in certain circumstances by proposing its retention for research and experimentation. This runs counter to the Treasury's own principle of economic neutrality and is contrary to the position taken by other proposals, such as Bradley-Gephardt. Nevertheless, it suggests the obvious; for reasons essential to the nation's economic well-being, it may be desirable to favor certain activities through the use of tax incentives.

C. Expensing of first $5,000 of business property.

The TDSP preserves the $5,000 deduction for newly acquired business property. The justification for doing so is that this is a de minimis amount best addressed under the provisions of the current law. At the same time, however, the increase in the amount of this deduction that would otherwise go into effect for future years is eliminated. Over time, then, as the effects of inflation are felt, the real value of this deduction will decline significantly to the point where the provision will afford no real economic incentive for investment in equipment.

Admittedly, the TDSP could have urged the immediate elimination of this expensing provision. Nonetheless, its stance, which amounts to progressive repeal, only serves to reinforce the strong bias in the TDSP against capital-intensive industry. The expensing provision is especially significant in fostering reinvestment by ongoing smaller enterprises, since it helps cushion the cost of upfront capital outlays.

There have been abuses with respect to this provision, especially the deduction of expense that should properly have been associated with personal use of equipment. Still, the provision has probably been helpful in stimulating capital investment in computers and similar advanced technology items. If anything, the expensing provision limit should be increased. This might be accompanied by restricting the deduction to investments in certain types of preferred assets.

D. Capital gains.

The challenge to capital investment posed by the introduction of RCRS, elimination of the investment tax credit, and the freezing of the expense deduction may be further intensified by the proposed elimination of the current lower capital gains rates. It has been argued that without the differential in rates, yet another incentive for investing in capital will have been eliminated.

Presently, investors in capital assets are granted a 60% deduction for long-term gain. The deduction serves a number of purposes, notably, the amelioration of a bunching effect on income upon disposition of the capital asset and the protection of the taxpayer from tax on nominal, as opposed to real, gain. The TDSP appears to solve the bunching problem through the elimination of most tax brackets. As for the concern over the tax on nominal gain, the TDSP suggests the indexation of the basis of the capital asset to the rate of inflation.

Despite contentions to the contrary, the TDSP affords the investor in some cases no less an incentive for capital investment then the current 60% deduction. This conclusion can be demonstrated by taking into account the interaction of several factors: anticipated inflation, real asset appreciation, the holding period of the asset, and marginal tax rates. The computations involving these factors are complex. Based on TDSP and other studies, it appears that in some instances the TDSP approach to capital gains would be a net plus for the investor and a detriment in other instances. The corporate investor, that is already being taxed at a 28% rate, would benefit from the TDSP position in fewer instances than the individual.

The foregoing suggests that the TDSP stance on capital gains is not as problematic as some of the other recommendations already reviewed. Nonetheless, in the case of real economic growth in a noninflationary environment, it could work as another disincentive to investment in capital-intensive activities. Moreover, it, too, would create severe business planning complications, with the advantage going to those able to correctly project the future of the economy and the long term potential of the asset in question.

Finally, the elimination of reduced capital gains rates could impinge upon the ability to raise equity capital. This might be particularly damaging to "High Tech" businesses, that typically experience significant real economic appreciation. Again, however, this is an uncertain proposition. The indexation of the interest deduction and the elimination of the 6 month capital gains holding period might make equity investments more appealing, as would the partial elimination of the tax on dividends. As with so much of the TDSP, the full impact of the changes being proposed simply cannot be predicted.

E. Effective rates of taxation.

In many respects, the most troubling aspect of the TDSP from the standpoint of the small businessman is the introduction of a 33% flat corporate tax rate. While this may represent a boon to certain corporations with high taxable income, it would also represent an increase in effective rate for many small corporations with taxable income under, for example, $125,000.

The change in the corporate tax rate would be harmful to all types of small companies. However, it would be particularly damaging to capital-intensive corporations. These companies will have also sacrificed such other tax benefits as ACRS and the investment tax credit.

F. Indexation of interest.

The TDSP recommends the indexation of interest, other than that paid on home mortgages and, in the case of individuals, an additional amount not in excess of $5,000. The purpose here is to exclude from income the portion of interest that does not represent real economic gain. On the expense side, the aim is to restrict the deduction to the real cost of borrowing money.

In theory, the TDSP position once again has its appeal. However, the practical implications of the proposal could be enormous. The indexation of interest would introduce a strong discentive to borrow. Any such change could conceivably produce a substantially higher cost of doing business for the small entrepeneur, who relies heavily on borrowing and for whom equity offerings are not a realistic possibility. As with other proposed changes, interest indexation could have its greatest impact on capital-intensive businesses and might bring down small marginal businesses unable to survive the transition to a more equity-oriented economy.

As I have pointed out previously, the full ramifications of change can hardly be anticipated. For example, the added cost to the typical real estate investor of this and other TDSP changes could result both in reduction of housing stock and an increase in the rent charged tenants.

G. Corporate capitalization and choice of entity to conduct business.

The proposal to afford a 50% deduction for dividends paid appears to be an excellent move that should assist small business. By increasing the appeal of equity financing, smaller companies that have been strapped for cash and have limited borrowing potential, may now have an alternative route for financing. Potentially, more money should also be available for reinvestment as the incentive to retain earnings in larger corporations recedes. The impulse to invest these earnings in unappealing properties so as to avoid the dividend tax should also weaken and stimulate the availability of capital. A similar effect may be produced by lower rates, which should make available funds that might otherwise have gone into tax shelters.

Another aspect of the TDSP that may be less appealing is the recommendation that limited partnerships having over 35 limited partners be treated as corporations. The motivation for such a classification is apparently the elimination of the tax shelter abuses associated with such partnerships. By reclassifying these partnerships as corporations, the pass-through benefits associated with the limited partnership vehicle would be unavailable. When considered along with the reduction in tax rates, the effect of this provision could be to stymy the financing efforts of relatively small and moderater independent entrepeneurs in such areas a real estae and oil and gas. Of course, rules will have to be promulgated to prevent use of smaller, multiple partnerships to avoid the 35-person rule. The result may be some added complexity to the tax law.

Smaller partnerships, general partnerships of all sizes, and Subchapter S corporations are all preserved by the TDSP on the ground that they are merely extensions of the individuals behind them. To the extent that a Subchapter S corporation or the partnership device is used to pass through losses it should still prove appealing, although some of the appeal will be gone due to the reduced benefit to be derived from losses. The Subchapter S vehicle may suffer further because of the dividends-paid deduction that will be available to regular corporations. The avoidance of double taxation of dividends through the use of the Subchapter S vehicle is no longer as compelling as it was.

On the whole, I believe these changes are positive. The mere technical form in which business is conducted probably should not determine the tax result.

H. The matching of income and expenses.

The TDSP continues the trend developed in the 1984 Tax Reform Act to require recovery of certain prepaid items over the life of an asset or upon its ultimate disposition. The industries in which these matching questions arise are typically mineral and farming-related.

In some cases involving tax shelters, there has been genuine abuse. On the other hand, the changes recommended by the TDSP may go too far and have the effect of unduly increasing the cost of doing business for legitimate businessmen in certain mineral and farming activities.

Conclusion

As the foregoing statement indicates, the TDSP is far more appealing in the abstract than in practice. The goals it sets forth are fundamentally unattainable and, indeed, the TDSP itself affords some of the very sort of preferences it condemns. With respect to its impact on small businessmen and investors, it would appear that the need for the services of an accountant or tax attorney wil remain undiminished. Business planning itself may actually prove more complex and unpredictable. Certain types of businesses, especially those that are capital-intensive, could suffer dramatically. Small corporations could actually experience an increase in their effective tax rate and low cost investments traditionally available for participation by middle class investors could become rarer.

More generally, the impact of TDSP on the overall health of the economy, a vital concern for the marginal, small businessman would be a major question mark. No one could presently venture a reliable prediction on the impact that such a radical transformation in tax law would have.

Of course, there is no guarantee that the TDSP could make it through the tax legislative process unaltered. Thus, the final result could be just another tax bill. Especially in light of heightened public expectations, the consequences of such a result could be a much greater discrediting of the tax system than has already occurred.

The tax system is simply a reflection of the complexity of our economic, social, and political processes. There are gross abuses and frustrations associated with the current law. These should be attacked methodically. Provisions must be fine-tuned, adapted to changing circumstances, and their interaction with each other properly understood. The search for a panacea to tax law ills is counter-productive and contributes to the law's ever-increasing complexity as one "solution" after another is enacted. In my opinion, the best course now would be to recognize that tax law cannot be totally simple or economically neutral, and to continue instead to refine incrementally the law that is presently in existence.

Senator SASSER. Our next panel consists of Mr. John Walsh, Tennessee's Small Businessperson of the Year for 1984, Mr. Eddie Settles, a distinguished Nashville lawyer who practices law with an old friend of mine, Irving Entrekin. Good to see you, Mr. Settles. Rounding out our second panel is Ms. Jane Jones, the president of Jane Jones Enterprises. She started from scratch this personnel and employment firm which is growing very rapidly. Ms. Jones is considered one of Nashville's leading business persons, and she's knowledgeable not only on taxation but also on unemployment. So we're delighted to have her with us today.

Mr. Walsh, why don't you lead off for us, please, sir.

STATEMENT OF JOHN WALSH, PRESIDENT, PORCELAIN INDUSTRIES

Mr. WALSH. Thank you, Senator.

My comments to you today will reflect my opinions as the owner of a small business employing approximately 95 people, after originally starting with 8 people, and doing an annual volume of business in excess of $8 million.

In my company we are very fortunate in that we enjoy a strong financial condition. We offer stable employment to our employees, and our profits from operations are and have been well above the level normally considered as satisfactory. We are in a growth cycle which began in earnest approximately 5 years ago and which is accelerating.

I chose to make these particular opening remarks because there is a definite relationship between the success that my company enjoys today and the present system of our Federal tax laws relating to the accelerated cost recovery system and the investment tax credit. A major portion of the growth and development of my company has occurred during the past 5 to 6 years. In 1978 we were struggling; our employment was down. In 1979, decisions were made to take major steps in the revitalization of our operations through the upgrading of our plant equipment and our manufacturing processes. From a financial point of view this, at that time, was a very difficult step to take but the decision was made; the revitalization was accomplished, and since that time, our trend line has been straight up. Without ACRS and the investment tax credit involved, and under the current corporate income tax structure, it is very doubtful that the revitalization of our company could have been accomplished in the manner in which it was.

In addition to the monetary incentives which our present tax system offers under the ACRS and the ITC, I feel that the rules established in 1981 accomplished much in the way of removing confusion and inconsistencies relating to depreciation. It was a great help to finally know and to be able to plan on an asset having a depreciable life of either 3, 5, 10, or—in the case of a building—18 years. Concerning the proposed change in the capital gains treatment, I feel that this presents a somewhat mixed bag with part of the bag containing reasons for change which are understandable, reasonable, and justifiable; but part of this same bag seems to contain the potential for unfair and even cruel results. It is understandable to me that the original thinking behind the 60-percent exemption relating to capital gains income was justified as a means of overcoming the unfairness of inflation. Inflation now having been brought under control, however, and with the proposed reduction in the tax rates, it would now seem reasonable that this 60 percent is no longer justified as far as chattels such as buildings and equipment are concerned. However, there are other categories of capital gains which I feel to be deserving of a different type of consideration. In the category of small business there are many thousands of entrepreneurs in this country who began their businesses with a small investment 10, 15, 25 years ago and have grown their businesses in spite of the difficulties imposed by and during the period of relatively high income taxation. Over the years, and as a result of individual efforts, these same entrepreneurs have seen the values of their companies increase not because of inflation but because of their willingness to take risks while applying their energies and their intelligence and determination. While expending their energies and at the same time paying the high corporate income tax, the value of their businesses have grown as a reward for their hard work and intelligence. Needless to say, while this growth was taking place their employment numbers have increased and, in many ways, they have contributed to the economy of the Nation. However, should these business developers wish now to sell their companies because of age, health considerations, or for whatever reason, they would be penalized severely—and in my opinion, most unfairly, should their capital gains exemption be taken away from them and should the monetary reward representing the fruits of their efforts be looked upon and taxed as ordinary income.

I am sure there are additional exceptions in this mixed bag which should be handled differently, but in my opinion this particular situation relating to the sale of a successful business is worthy of, and even demands, close study and special consideration.

It is said that true confession is good for the soul, and my true confession for today will come in the form of my closing remarks. When I first heard and read the rather sketchy reports concerning the Treasury Department's tax reform and simplification proposals as they relate to small business, my reactions were totally and definitely negative. However, I have attempted to prepare myself for this hearing with an open mind and from an unbiased standpoint. I must point out, however, that my opinions are primarily a reflection of the thinking of the owner of a business as described in my opening remarks.

I have attempted to weigh the pros and cons of the present system as opposed to the system under which we would operate our businesses if and when the new proposals are adopted. I now more clearly understand the reasoning and the justification of the installation of the present system of ACRS and ITC, and these systems were excellent when used as originally intended. However, today we are operating under a new set of circumstances and possibly a new system of rules is called for. The justification of our present system, I feel, at best is questionable. There can be little doubt that many of the multinational corporations and other companies far outside of the definition describing small business have found ways to use our present tax system far beyond the original intentions of this system. There can be no justifiable nor supportable reason why a highly profitable multinational company should pay less in corporate income taxes than Porcelain Industries, Inc. of Nashville, TN. And it's my opinion that the new proposals could go a long way toward rectifying this situation.

It is also my opinion that the reduction in the corporate tax rate from 46 percent to 33 percent, which amounts to a 28-percent reduction, is sufficient to overcome the loss which would result from the cancellation of ACRS and ITC in most cases. Understandably, this would not reflect the opinion nor the preferences of the GE's nor the GM's because theirs is a different ball game, but it does reflect the opinion and the preference of PI, which happens to be the not quite so well known symbol of my company, Porcelain Industries.

I feel that the proposals of the Treasury Department are good for our country and good for small business in general, and I commend Mr. Regan and his staff at Treasury for the product of their energies and their intelligence.

Thank you, sir.

Senator **Sasser**. Thank you very much, Mr. Walsh.

Ms. Jones, we'll let you go next and let Mr. Settles, as the lawyer in the group, have the last word, as lawyers usually do.

STATEMENT OF JANE JONES, JANE JONES ENTERPRISES

Ms. **Jones**. Thank you.

I am taking this opportunity to thank the Senate Small Business Committee for allowing me to give the following testimony. I am attempting to represent to this committee my opinion regarding the Treasury tax plan and its overall potential effect on small business.

Sir, I'd like to set the record straight; I'm not an expert in anything—in small business, you simply have to try to know a little bit about everything—I'm certainly not an expert in taxation. So I felt I needed some advice in order to be able to testify today, and the approach that I took was to call a tax attorney, two CPA's, my corporate attorney, a pension expert, and several leading small business people, just to get a general feel.

Sir, I'd like to also report to you that in talking to those eight people, I got eight different opinions; needless to say, that didn't give me something that I felt worthy of testifying about. So my next approach was to simply try to get on overview of this tax and other taxes that had been proposed by using a "plus/minus" system on them, weighing the advantages and disadvantages as I saw them, in hopes of being able then to lay out the key issues; and still, I did not arrive at a clear, concise picture. My compliments should be sent to the authors of this proposal, who obviously labored many thoughtful hours in putting it together. Many of the items contained in it do have some benefits, at least on paper: The reduction of corporate income tax rates is appealing, and the proposed reduction in double taxation to corporations should, if rectified, be able to help other investors be willing to invest in small business.

I'm sure, as everyone has stated, that the intent of this proposal is for fairness and simplification; but to the best of my ability, I've been unable to determine any really great benefits of this proposal as it relates to small business. If small businesses are to continue to be the backbone of the American free enterprise system, and if we're to continue to encourage what's considered the entrepreneurial explosion in this country, any tax reform that is proposed will have to have very clear-cut, well-defined benefits that will encourage these people to take the risks involved. That encouragement is not obvious to me.

In 1977 I started a small business with $1,000—obviously, a ridiculous amount of money to try to start a corporation with. Things like the new jobs tax credit, the investment tax credits and other financial tax benefits gave me an opportunity to accumulate some assets in this company. I therefore was able to, in an 8-year period of time, create approximately 24,000 jobs for Nashvillians. I don't see anything indicated here that would encourage new business. It seems that some of these things are being taken away.

In this last 8 years, then, I've been allowed to work in a country that encourages the average poor citizen to look at the opportunities available and to decide whether the risk/reward ratio is there and beneficial to us.

As I reviewed this tax proposal, I could not help but sense a feeling from some of the people I spoke with that this is some kind of contest. We keep changing and changing; in business, one of the earliest principles I learned was that, whenever possible, a company should never knowingly give to its employees a benefit that would later be taken away. It certainly affects morale of individuals.

I think that the proposed taxing (even though there is a cap on it of insurance benefits of any kind) might be misunderstood because the average small businessperson spends all their day trying to stay even, trying to at least get a little ahead of the system; and their misconceptions of changes and tax reforms and things like this might encourage them to limit the advantages that they give to their employees in health insurance and things of that nature.

In addition, keyman/keywoman life insurances always need to be made available because if you start a new business and you do not have any personal money yourself, you need to be able to insure that your company can continue, if you should reach an untimely demise; the insurance needs to be able to be there to pay the loans and things like this.

I'd like to point out that this proposal's attempt to eliminate tax shelters, investment tax credits, accelerated depreciation and capital gains may not be perceived accurately. Very few people sit down and read through 480 pages to determine what their opinions are. They get a lot of their opinions from other people and what they hear in the market.

So I think that the frightening question to me is, will Government be able to adequately explain, in a simplified form, the reasons that these areas are now going to be excluded? If not, I'm afraid that a growing number of Americans will perceive this tax as unfair and may develop an unwillingness to render to the Government what they feel rightfully belongs to them—an attitude, sir, that I would suggest this country cannot afford to have happen.

In closing, I would like to say that I am in favor of taxation that is fair to all people. It would be my recommendation that whatever tax laws are passed not be counterproductive to simplicity. Since small business, as has been mentioned already today, cannot afford to pay the $85 to $100 an hour to call the experts to find out what this means to us.

What is needed, in my opinion, is tax reform that would be adequate for this country for several years, giving us in small business an opportunity to be able to plan for our tax position. If we can understand what's happening to us and know that it's fair and it's simplified, then we can cut down on a great deal of that and go back to work. A lot of the things that are happening to us from this point in—for example, keeping the logs; how in the world can a person log every second that they're in and out? These things are complicating our businesses and, indeed, will cost us in sales, ultimately.

Thank you.

Senator SASSER. Thank you very much, Ms. Jones.

We'll hear now from Mr. Thomas E. Settles.

STATEMENT OF THOMAS E. SETTLES, ATTORNEY AT LAW, TUNE, ENTREKIN & WHITE

Mr. SETTLES. Senator, I appreciate being given the opportunity to come before you today and share with you some thoughts that I've developed over about the last 15 years. Just so you'll know my frame of reference, I started out my professional life as a CPA in Memphis, worked for about 3 years there before moving on to Vanderbilt Law School and ending up as a lawyer.

Some of the things that I have to say today will be, I think, significantly different than what's been said by other witnesses. And I think it's probably against my special interests as a tax attorney, but I think it would probably be, I think, in the best interests of the country at large.

The first thing I'd like to address is this: I believe, over the past 12 years that I've been in practice, either as a CPA or as an attorney, there's been a remarkable decline in the respect for the rule of law as it affects our revenue system. I think that the difference between the way people felt about the fairness of the tax system 12 years ago is very different than it is today. I can't count the number of calls that I usually receive beginning about April 1 from people who say, "I haven't paid taxes for many years; is there a way for me to continue to avoid it?" I can't give them any comfort there, but I do believe that there's a general sense in the populace that the laws raising taxes are fundamentally unfair.

What I think I see our society headed toward is a tax system very similar to the French. The French taxing system basically makes a liar—or a policeman—out of each successive person in the chain. They do not, in fact, get a credit for their tax paid unless they report what the person downline paid before them. And I truly believe that if our society revolves around respect for law, that we are headed in the wrong direction in our past tax changes.

So my plea overall would be, whatever you do, whatever the Congress of the United States does, needs to result in a perception of fairness among all levels of society; and I do not think that the current set of laws promotes that.

I think one of the reasons for this feeling is that we have engaged, at least since 1954, in using the Tax Code for social engineering. There is nothing wrong with that as long as the society at large agrees that's the appropriate thing to do in the Tax Code. I do not think there is any longer a consensus for that. There is always a perception of "not my job, but someone else's," "not my tax benefit, but someone else's benefit." But when you all sit down in Congress to try to broker all of those special interests that necessarily come to you, I think that you have now reached a point of finding it impossible to juggle all of them at one time. What I see eventually happening is a total inability to broker all of those various interests. I would plead that you not engage in an industrial policy through the Tax Code. Although I agree with Professor Schoenblum that it is certainly more efficient to have a tax incentive than a direct subsidy, I would make a plea for no subsidy and no tax incentive.

The second item that I'd like to address is the fee question that several of the folks who've been here today have suggested to you. Although it is certainly very profitable to me to render advice at rates in excess of $100 an hour for tax advice, I'm not sure it is very beneficial to my clients to have to call, on a regular basis, to decide whether or not they can make a business decision because of the tax impact. Whether as a CPA or as an attorney, I do not think we're adding anything to the wealth of the country by having consistently to interpret for our clients business decisions in the light of tax laws. I always say, the tax tail wags the economic dog. That's not appropriate, in my opinion.

The third item I'd like to touch on is that I believe it's important for the Tax Code to become neutral insofar as it has an incentive for something other than earning greater amounts of income. We need to get away from creating industries that revolve around tax gimmicks. Between October 1 and December 31 of each year, I spend incredible amounts of time reviewing prospectuses for business transactions for clients that add nothing to the wealth of the nation, they simply result in lower tax burdens.

The third item I would like to suggest is that I think it is inappropriate for investment tax credits to be used to subsidize capital-intensive industries. It is true that the Japanese and many other nations do subsidize them, but I think it's also true that as long as their citizens are willing to pay their government to subsidize our use of those interests, we should welcome the subsidy, but not make the mistake of repeating it in our ecomomy. I realize that that creates pain for individual segments of our society, but I think that we're fooling ourselves if we think we can avoid the ultimate negotive payoff for obstructing market forces.

Finally, I'd like to touch on the fact that I believe that it is important for business people to have some certainty as to what will happen. Since I have been practicing law, there have been major revisions on an average of every 18 months. My partners and I spend incredible amounts of money trying to keep up, ourselves, with what the law is, much less in trying to inform our clients what the law is. There is no way for a businessman to make a long-term decision when he realizes that, within 18 months, the deal will indeed change.

In terms of the details of the Treasury's bill, I think that investment tax credits are important to small business people. I do see them taking advantage of it; but quite frankly, most of the small business people that I know take advantage of the investment tax credits outside of the corporation, not inside the corporation. With appropriate tax planning, very few of my clients pay corporate income tax; they pay personal income tax if the planning has been done correctly.

On the question of double taxation of dividends, I think it is a terrible commentary on our society that we attempt to benefit large aggregations of capital, in the form of GM or Ford or whoever it might be, instead of giving incentive to those managements to be required to disburse the cash into the hands of the shareholders. The shareholders could, in fact, make their own rational decisions rather than management making it for them in terms of what business is a winner and what is a loser.

The final comment I'd like to make is with regard to tax shelters. I make much of my daily bread in advising tax shelters promoters, and I'm sure there are those who promote them who will not be happy with my discussion. I see no economic benefit from many, many of the tax shelters that are sold except for subsidizing high-income taxpayers at the cost of wealth-creating not benefited by our Tax Code.

Thank you for the opportunity to discuss these things with you.

Senator SASSER. Well, thank you very much. Let me ask you this, Mr. Settles, just straight out. From what you've seen so far of the proposed tax reform bill put forward by the Treasury Department, would you favor that legislation or oppose it?

Mr. SETTLES. Senator, I would favor it. If I may tell you one brief story, Ervin Entrekin, who you know and I sat before our computer as the Treasury Department's proposal came over the line and I said, "Erv, have you ever seen anything like this in your whole life?" His comment was, "No, Eddie, in the 30 years I've practiced I've never seen anything this dramatic." We both believe that the only way to attack the abuses in the system is to attack on all fronts at once. Otherwise, the special interests will, in fact, pick the carcass of the reform bill. So yes, sir, I, for one, am favorably impressed with it.

Senator SASSER. Mr. Walsh, initially you said you were opposed to the bill but you looked at it with an open mind and tried to take an unbiased approach to it; and after looking at it with an open mind and taking an unbiased approach, I gather you're more favorable disposed to it? Is that an accurate statement?

Mr. WALSH. Yes, I am. What we actually did, Senator, we went back in my company for 4 years. During these 4 years we had varying amounts, but consistently we had investment tax credit and ACRS involved in our year-end operating figures. In all 4 years, the new system would be a definite monetary advantage to us.

I think a lot of us automatically are negative when we hear of a new tax system. I think in this place, a lot of people are looking at what's being taken away and they are giving no consideration to the fact that there is a hefty reduction in corporate income taxes involved also.

Now, let me add one thing, that I do not conclude my remarks——

Senator **Sasser**. You mean a hefty reduction in corporate rates.

Mr. **Walsh**. Yes.

Senator **Sasser**. Down from 46 percent to 33 percent.

Mr. **Walsh**. Right, which is a 28-percent reduction.

I would agree—I did not conclude my remarks, but I would agree that there should be a step, a method of taxation for the very small businesses.

Senator **Sasser**. You're talking about a tiered approach?

Mr. **Walsh**. Yes; Yes; yes.

Senator **Sasser**. Well, let me just ask the panel this question: Do you believe there would be a sharp drop-off in small business investment activity if the investment tax credit was repealed? Anybody want to respond to that?

Mr. **Settles**. I'd say, Senator, there will not be. As I mentioned, most of the investment that I see made by my clients is made by individuals. It's made by individuals obviously so that the individuals may take the benefit directly on their tax returns as opposed to the corporate tax returns. Small businesses, by and large, do not make uneconomic decisions because they do not have the substantial profits against which to set off those tax credits. So they buy capital assets when those assets will produce a return greater than the tax bite. If the tax bite is reduced, even though the investment tax credits are taken away, I think there will still be sufficient incentive for those investments that are economic to be made.

Mr. **Walsh**. I would agree; and also, a lot of small business—in the manufacturing area, a lot of decisions about, "Are we going to spend $100,000 for this improvement?" is based on their current condition cashwise. And that current condition cashwise is going to be drastically affected by the reduction in their output for income tax.

Senator **Sasser**. Ms. Jones, I judge by your testimony today that perhaps you're a little more dubious of the new tax reform law that's being proposed than, maybe, the other members of our panel. Is that an accurate statement?

Ms. **Jones**. Yes; it is.

Senator **Sasser**. What are your chief reservations about it?

Ms. **Jones**. Well, as I mentioned originally, I don't see any things that just jump out at you as opportunities for a business. In other words, I think that—for example, for any of us to really understand this, there has to be some concrete decisions made as to whether they will take away the investment tax credits; and then we have to be able to look at our individual businesses and see what will happen. Obviously, my interest in new jobs tax credit would be obvious because it is certainly a shot in the arm to my business.

But that is what I was trying to say. Being a person involved in just running a business every day, and not being an expert as many of these people are in taxation and the laws that affect a business, the incentive did not just jump out at me, as if, "Hey, this is good for all small businesses." So that's the reason. I think I'd be willing to hear all testimonies before I made a final decision on it, but I am more skeptical. I think you'll find people are skeptical of change period, and as has been testified, we've had so much change it starts to be confusing.

Senator **SASSER**. Well, thank you very much for your comments today. We may have some different questions which we'd like to submit to you in writing.

Thank you very much.

Our next panel will consist of Mr. Wayne Oldham, a well-known business figure in this community who is the president of the Southern Hospitality Corp., which operates, among other things, Ireland's, Wendy's franchises, Mr. Gatti's, and several other independent restaurants. Welcome, Mr. Oldham. We're glad to have you here.

Mr. **OLDHAM**. Thank you, sir. Thank you very much.

Senator **SASSER**. You'll be joined by Mike Bateman, who has testified before the Small Business Committee in Washington on targeted job credit legislation. Mr. Bateman is a distinguished certified public accountant in the city and is, I might say, a very articulate and thoughtful witness. And also Mr. Bill Freeman, the president of Freeman Webb here in this city. Mr. Freeman is one of the most successful young businessmen in Nashville; if there's anyone who knows how to make a success of a small business, I think Bill Freeman does.

So we welcome this distinguished panel, and Mr. Oldham, we'll start from my right to my left—with you, please, sir.

STATEMENT OF R. WAYNE OLDHAM, CHAIRMAN, SOUTHERN HOSPITALITY CORP.

Mr. **OLDHAM**. Thank you very much, Senator. It's a pleasure to be here. When Mr. Freeman, my distinguished colleague, arrived today he came over and wanted to know what I was doing in a small business meeting. I reminded him that I remember very distinctly, many years ago, when I had less than 100 employees; I remember when I had only 1, as a matter of fact. And if this proposal were adopted that the Treasury Department has recommended, I might still have only one employee. [General laughter.]

But I do thank you very much for the opportunity to be here in these field hearings to explore the impact of the tax reform and simplification proposals on small business.

These proposals, in my opinion, would significantly impact small business, and I'd like to discuss a couple of those. A lot of those have already been covered, and I'd hate to go over some things, but I think for emphasis I might do that.

Alexander Hamilton was quoted in the Federalist as saying:

> It will be of little avail to the people that the laws are made by men of their own choice if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man who knows what the law is today can guess what it will be tomorrow.

And I think that's the situation we're finding ourselves in today in all the tax laws, especially as they affect small business.

The collection of the income tax revenue in this country, of course, is founded on the principle that every citizen and business are to assess themselves the income tax that each owes under the law. And there are substantial punitive provisions for those people who don't do that. The income tax laws of this country now, in my opinion, are much too complex and technical, and every day that goes by they are becoming even more so. And I'm just afraid that if we don't do something about all of that, that we're pretty soon going to be crushed under the weight of all of those complexities.

The Treasury Department's proposal contains several provisions which would add significantly to the complexity of the tax laws and increase the cost of compliance with these laws for the small businessman. One example which has already been mentioned but needs to be, I think, mentioned again, is the replacement of the accelerated cost recovery system with a system that indexes the tax basis on depreciable assets for inflation, and increases the number of recovery classes from five to seven. We all know that the burden of that, obviously, falls right on the taxpayer and the expense would have to be borne by the taxpayer. It runs the risk, and I think almost definitely would be a nightmare as far as administration is concerned, because we have to maintain the asset cost depreciation records for financial accounting on a historical basis for who knows how many years.

The problem, it seems, is that no one seems to be concerned about the complexities, and that the drafters of the legislation seem to be technicians who don't seem to be accountable to anybody. And they're really out of touch, it seems to me, with the practical application of what the law really is.

In August of 1981, the Economic Recovery Tax Act was passed and was billed by the Reagan administration as the largest tax cut in history, like almost $750 billion over about a 6-year period. Among the ERTA provisions was the accelerated cost recovery system, which was designed to spur investment on the part of business. Now, then, less than 4 years later, they say that that's not what they want. The same administration proposes to repeal that, along with the ITC, and replace them with a system that provides no initial incentive such as the ITC for investment in capital assets and substantially extends the period over which the cost of the capital assets can be recovered. Business, which adopted intermediate and long-range plans—that's one of the big problems here, is that about the time that you get a 2-, 3-, 4- or 5-year plan in your company put together, the Government comes along and changes the tax rates and the laws and all those sorts of things, and you've got to go back to square 1 and start over. It's apparent that most of the people up there who are drafting these things don't understand the problems inherent therein.

Philosophically, I just wish the Government would adopt a few more of the basic elements of business planning, including the things I just talked about, and develop a plan that makes some sense and is solid and manageable, and stick to it. After all, the Government and business have to work together if we're going to succeed. It's supposed to be a government of the people anyway, as I know it.

And finally, the proposals to eliminate the ITC and direct expensing of all or a portion of equipment costs, as well as the repeal of the ACRS, I think, I really think, would result in lower levels of capital expenditures. I really believe that, especially small businesses who don't have the access to the equity markets like the big businesses do. It makes a heck of a big difference, I think.

The Treasury proposals will increase significantly the effective tax rates for small business, thus reducing the amounts of profits available for growth and expansion. And all of the increased employment in our economy in the past decade has come from small businesses and not from the Fortune 1000 companies. And I think that's a very important point.

It's easy to predict the impact that the Treasury proposal will have on our economy in my opinion, and I'd certainly hate to see it become law. I'm very concerned about it.

Thank you very much, Senator.

Senator **Sasser**. Thank you very much, Mr. Oldham, and we'll have some questions for you in just a moment.

Let's hear now from Mr. Bill Freeman and see what his views are on this tax bill.

STATEMENT OF WILLIAM H. FREEMAN, PRESIDENT, FREEMAN WEBB CO., REALTORS

Mr. **Freeman**. Senator, I appreciate the opportunity to be here.

I'd like to focus my remarks on how the Treasury proposal impacts the real estate business since that's where most of my Interest is. I have reviewed the proposals in light of that.

In general, the Treasury proposal has several devastating effects on home ownership and the real estate industry. The value of private property would be sharply affected, and in the new proposal they provided much less incentive to invest in the development and invest in existing apartment buildings, shopping centers, office buildings, and other commercial properties. The proposal calls for a decrease in depreciation allowances from 5½ percent each year—that's based on an 18-year, straight-line depreciation—to 3 percent each year. On a present value basis the value of depreciation would decline by at least 11 percent, resulting in about 10 percent decline in investment each year; and the value of all existing depreciable real property would decline by an equal amount. These numbers are based on a recent study conducted by Dr. Jack Carlson, the chief economist of the National Association of Realtors.

The other thing to keep in mind is that these tax increases on real property would by and large flow through to tenants. In multifamily residential properties, rents for existing apartments likely would increase by at least $300 a year, which would consume an additional 2.25 percent of the average renter's household income. And for the one-third of the Nation's renters who have incomes below $18,000, rent increases would consume an additional 5½ percent or more of their incomes.

Thus the depreciation provisions in the tax proposal seem to place an additional financial burden on the Nation's poor. The financial impact on the poor would be further aggravated by the Treasury's proposal to eliminate the special depreciation treatment for low-income housing. Low income housing can now be depreciated over 15 years, but that provision would be eliminated under the new proposal.

The objectives of today's depreciation laws and investment tax credits are to make America's plants and equipment more competitive and to provide incentives for certain types of development. These new rules would no longer be a means toward that goal. The proposed treatment of depreciation likely would not allow investors to recover enough through depreciation to replace worn-out structures before they become economically insufficient or obsolete.

If I could just touch briefly, too, in the ITC question. I heard several comments today about the importance of that. We were sitting in the back of the room, Wayne and I, talking about how many times the decision to expand or to buy a piece of equipment, a computer or a piece of equipment used in our businesses, how many times that decision has hinged on the fact that the ITC will be there—we maybe can't afford it or maybe could put it off—but the ITC is many times, time and time again, that overriding factor that pushes us over the fence and causes us to expand and buy a piece of equipment.

In terms of the impact of the Treasury's proposal on home ownership, it has been calculated that the annual after tax cost of owning and maintaining the average price home will increase by more than a thousand dollars. The increased cost of owning one's home would also reduce the value of the average price home by $10,000, again, according to the study conducted by Dr. Jack Carlson.

The implementation of the Treasury plan would significantly increase the cost of owning a home. Under the current tax law an individual buying an average price existing single family home for $85,000 with a 20-percent downpayment, a $68,000 mortgage, 13 percent interest over 30 years would pay $8,840 in interest during the first year, and $1,700 in real property taxes. The before tax cost of mortgage interest and property taxes would be $10,540, and to qualify for such a mortgage loan the family would need an estimated $36,000 annual income. With four family members, the home owner would be in the 25-percent marginal tax bracket, and deductions for mortgage interest and property tax would bring the homeowner $1,785 in tax savings. Thus the after tax cost of owning that home would be $8,755.

Under the Treasury plan the home owner would not be able to deduct property taxes and his marginal rate would fall to 15 percent. His tax savings due to available deductions would be only $1,326, and the after tax cost of owning the same home would rise $1,309 to a total of $9,200 per year.

That $1,300 increase in the yearly cost of owning a home would be equivalent to a 2-point increase in mortgage interest rates. The example is based on only the average price single family home and the effects of the proposal would be much more severe in areas where large portions of housing are priced well above the national average.

To put this number in perspective, as of December 28, 1984, the average sales price, according to the National Board of Realtors in their last system was $79,246.

Senator **Sasser**. That's the average sale price of a dwelling house in Davidson County?

Mr. **Freeman**. Yes, sir.

As you can see, those numbers translate very easily into the Davidson County real estate market.

It has been calculated that as many as 800,000 fewer families per year would purchase their homes if this plan were adopted. That decline in the number of homes would be the result of 500,000 fewer existing single family homes and 300,000 fewer new homes being built. The impact that this would have in the real estate industry, the home building industry, and other related construction industries would be dramatic, to say the least.

The overall decline in demand for housing would cause the value of an average price existing home to fall significantly. The typical home owner has a substantial portion of his assets and net worth in the equity of his home. The typical home owner's equity is about 60 percent of the home's value, but about 20 percent of this equity would be lost under the tax plan.

The final area I want to touch on is the impact the Treasury proposal would have on investment of commercial properties—apartment buildings, office buildings, shopping centers. The changes in the treatment of capital gains, depreciation, and partnerships make a significantly lower incentive to invest in these types of properties. If the Treasury plan were implemented, it could well mean a significant reduction in future investment in these structures, and thus a slower growth in the American standard of living. It would push the burden of developing housing, and especially low income housing, back onto the Government at a time when new housing programs, in addition to being unpopular and inefficient, are not affordable.

Thank you very much.

Senator **Sasser**. Thank you very much, Bill. Let me just ask you this. I take it from your prepared statement there that the National Association of Realtors are dubious about this tax reform. Have they taken any formal position on it yet, to your knowledge?

Mr. **Freeman**. Many of the concerns that I have raised are reflected in the concerns raised by the National Association. In terms of alternative proposals I don't know that they have focused on any one alternative as much as being opposed to the Treasury plan. I know there has been a great deal of discussion about the Bradley-Gephardt alternative, and many of the alternatives in that plan—the ability to expense property taxes and other things—would have much less of an impact on the real estate industry.

Senator **Sasser**. My guess is they're probably in the process of trying to shape this tax reform bill now rather than take a position of just outright opposition to it.

Mr. **Freeman**. Right, sir.

Senator **Sasser**. We'll hear now from Mike Bateman, our certified public accountant.

STATEMENT OF MIKE BATEMAN, CERTIFIED PUBLIC ACCOUNTANT, NASHVILLE, TN

Mr. **Bateman**. Well, I've got a tough act to follow here. I don't know if there's any significance to the fact that I'm the last one, either.

Senator **Sasser**. We saved the best for last.

Mr. **Bateman**. Oh, is that right? I thought maybe it was because you and I have some differences in political viewpoints.

Senator **Sasser**. No, no. I didn't know we had any differences. [General laughter.]

I'm learning something.

Mr. **Bateman**. OK. Your staff people knew it, anyway.

When I was asked to speak again, Senator, I had to do a lot of thinking and the more I thought about it the more I realized that even though we're talking about tax simplification, we're not talking about simplification. We've got an extremely complex issue. You've heard these various people talk from the real estate concerns, personnel people, others who depend on investment credits and ACRS and who depend on the section 179 writeoff. I don't think anybody can really determine what the impact would be of any of these changes. And if you want to know my honest opinion about it, my feeling is, let's not change anything. The Tax Code that we're working under now was developed in 1954 and we've had 30 years to work with it. Congress has come along and created some incentives for small business people through section 179; you were very active in that. We used to have a good jobs credit program that Jane Jones spoke about. The investment tax credits—the ACRS, which most of my clients found very favorable—all of these things have been enacted. But yet, we've seen over the past few years that these things that are designed to benefit small business people have been chipped away by Congress anyway. If you take full investment credit, then you take a reduced depreciation deduction. If you take a full depreciation deduction, you take a reduced investment tax credit. You know, we've got to look at the purpose of taxation in general. It's for the purpose of raising revenues for the Federal Government, and I cannot help but believe that anything that the Treasury Department would come up with would not be an effort on their part to maximize their revenues.

You made, I thought, a very important statement right at the beginning when you recognized and told us the number of small business—you know, how important small business is to America and the vastness of the small business people and the individual taxpayers. All that's telling me, Senator, is that when Congress collects the tax money they're going to get it from those people because they represent the bulk of America. And no matter how we change it, in my opinion, those people are not going to pay any less; if anything, I have a feeling that the Treasury proposals will, in most cases, increase revenues for the Federal Government.

It's kind of interesting. When I asked various people about their concept of this proposal, do you know the very first thing every one of them just consistently, every one of them asked me or said to me, "Why are they spending money on this, that, and the other?" They were less concerned about the new tax law proposal than they were about your spending efforts. I mean, I even have people giving me newspaper clippings about Government spending, and they ask me these questions, which I have no answer for.

So the point that I'm making is that I think we can work with the code as it exists right now if we would just make some changes.

I'd like to talk about specific things. I think it's interesting that we're talking about small business people. I don't know if there's going to be any hearings on big business people and the effect of this tax law change on big business.

Senator **Sasser**. Well, the big business people have a way of getting their views known without hearings. [General laughter.]

Mr. **Bateman**. Well, I realize that and I'm going to cite you a couple of examples, if I may, Senator. This is an explanation of the current tax law. It says, "Delay in NOL carryover rules. The 1984 act generally postpones until January 1, 1986, the application of amendments made by the Tax Reform Act of 1976, to code sections 382 and 383 dealing with the carryover of corporate net operating losses and other corporate tax attributes upon an acquisition or reorganization." There's no doubt in my mind, Senator, that that is a result of lobbying efforts by major corporations who are in the process of a takeover of another company that has favorable tax attributes that they want to continue, because the law now says if I acquire a corporation with loss carry forwards or investment tax credit carry forwards, basically, if I carry on substantially the same business—this is a simplification—I can take benefit of those. But the new law, the one that was enacted in 1976 basically said that as the change in ownership approaches 100 percent, these tax attributes are gone. So there's no tax advantage to an acquisition. That's a big corporation problem; to me, that's an area that ought to be looked at.

Special interests that affect large corporations—I'd like to read another law that came out in the Tax Equity and Fiscal Responsibility Act of 1982. This is an explanation of the law; it's code section 447g. It says, "For tax years beginning after 1981, a qualified partnership is permitted to use the annual accrual method of accounting under code section 447g and currently deduct preproductive period expenses instead of capitalizing them." And we know, in tax law, that if you can deduct something today, that's better than having to capitalize it and amortize it over a period of time. Qualified partnerships can deduct preproductive periods that otherwise would have had to have been capitalized. A qualified partnership is a partnership that engages in the business of growing sugarcane and that consists solely of corporations other than personal holding companies and subchapter S corporations. Act section 230 amending code section 447g. What that's telling me, according to the Internal Revenue code right now, we have a definition of small business under code section 1244. Sub-S corporations and personal holding companies have to fall under code section 1244. What they're saying is, well, they can't be small corporations; they've got to be big corporations involved in growing sugarcane. There's an inequity. I don't see why we should concern ourselves as to whether or not——

Senator SASSER. You don't suppose that has anything to do with the fact that Senator Russell Long of Louisiana is on the Senate Finance Committee that writes those rules?

Mr. BATEMAN. I got it right. I can cite you other things. For example, real estate——

Mr. OLDHAM. Coincidental?

Mr. BATEMAN. Coincidental. [General laughter.]

I can cite you another example, Senator, in the real estate business. I've forgotten in which tax act it was, in order to reduce the effectiveness of tax sheltered investment they came up with the concept of, well, you're allowed to take losses to the extent that you have an investment at risk. But that doesn't apply to residential real estate complexes, and I find that significant, too, because I can't help but believe that some Senators and Congressmen are probably heavily involved in real estate tax shelter partnerships. That's just a personal opinion I have.

But these are the types of things that we have in our existing code that, in my opinion, can be modified to take away this apparent inequity, and I feel that the reason for all these hearings and the reason for the idea of changing the tax law is because there is an apparent feeling of inequity in this country; you know, "I'm paying more than my share and he's not paying his share." Well, I'm not so sure, Senator, that when all this is done and when all the smoke blows away, that we're not going to be back in the same boat that we're in right now. My feeling is that what we have has worked. We have section 179. We have ACRS. We have a lot of benefits that have no significance to General Motors; a $5,000 expensing election has no significance to them whatsoever. But to Brookmeade Hardware & Supply Co., it's a significant amount of money, $10,000 would be. You know, I just find it interesting that all these proposals and all these amendments are directed to the small businessmen when, when it's all over with, there's not going to be a change in their tax liability anyway, I'm convinced of that. I'm convinced of that.

All I see here is just an attempt by Congress to make it appear that there's going to be more fairness, and I'm not sure that there's going to be.

Senator SASSER. Let me correct you there and say that this is not Congress' bill. This is the Treasury Department's bill.

Mr. BATEMAN. Yes, but Congress has an interest in it and Congress is going to vote on it. Congress is going to come up with something; I know that change is going to be inevitable. My suggestion to you and to this committee is, well, let's not have a wholesale change; let's look at what we've got and try to stay away from the pressures of these special interest groups, the sugarcane growing partnerships, and change what we have because there are a lot of good things in our current tax laws, Senator. And I just fear that, through the Treasury's proposal, that most of these good things that affect small business people are going to be eliminated simply as an attempt to raise revenues to reduce the deficit. My feeling about that, as to where your responsibility is, is to cut spending; don't raise revenues.

I guess I've said enough, Senator.

Senator Sasser. Well, let me ask you this, Mr. Bateman. How many of your clients make use of corporate tax returns and how many file individual tax returns?

Mr. Bateman. I assume that you're talking about as they relate to a business operation?

Senator Sasser. Yes.

Mr. Bateman. I would say that about half of my clients file either way. In general, unless they are earning significant amounts of money in their business, I don't particularly agree with the corporate form of operation unless there's significant outside risk. I'm talking about strictly from a tax situation. But I would say about half of them do that.

One of the things that I had thought about, Senator, in that regard is to make a separate tax rate structure for schedule C and schedule F, that is, for most of your business type income reported on a tax return, and make that equal to the corporate tax rates to make some sense of fairness and equity because corporate rates are more favorable in general than individual rates.

Senator Sasser. Mr. Oldham, the Treasury Department maintains that the current progressive rate structure for corporations serves no affirmative purpose. Would you agree with the Treasury Department on that or not? In other words, they want to get us away from a progressive rate structure for corporations and move us to a flat rate.

Mr. Oldham. Well, I think the thing that needs not to happen in business today is anything that is going to increase the tax rates on any kind of basis. More and more—and no one has mentioned this—but more and more, what's happening today is that the Federal Government has put more of the burden of social programs back in the local hands, which is where it ought to be. I'm not arguing about that, the charitable organizations and social programs. But that money's got to come from business. When I get to my office today there'll be a line of folks waiting to see me about giving them money to help this association, that association, and the other. And it's falling on business. The only way you can do that is to make a better profit and pay less taxes in order to help out your social programs. And I think they should go there as opposed to so much of going to the Federal Government.

So anything that is going to increase taxation to corporations, large or small, I think is not right.

Senator Sasser. Bill Freeman, if you had to pick out one or two of the most important elements of the Treasury proposal that would impact on the real estate industry, what do you think they would be?

Mr. Freeman. Senator, one of the things that really concerns me would be the repeal of the at risk provisions as they apply to real estate. Real estate development is very much like someone buying a single family home. You don't pay all cash; there's a good deal of leverage and financing, and the ability to appreciate and to expense more than the actual cash amount is a great incentive in the development of multifamily housing and other real estate. And that's one area that concerns me.

The change in depreciation laws is another area. The ability to buy a piece of income-producing property and to make any kind of long-range plan or forecast over the next 3 to 5 years is very difficult with the changes taking place as fast as they are. So those two areas are very important to me.

Senator Sasser. The tax policy writers over in the Treasury Department say that the distinction in tax rates between ordinary income and capital gains is a source of substantial confusion to taxpayers. I can't believe that this panel here would find that would give you any great difficulty in preparing your tax returns; if you're smart enough to be in business, obviously you know the distinction between capital gains and ordinary income. But they keep saying that, and I can't see how in the world that has any impact on small business people.

Well, let me ask you about something that we talked about earlier that I've worked on. Does the direct expensing concept create an investment incentive for small business, in the judgment of any one of you?

Mr. Oldham. I personally think it does. The smaller the business, the more it has a definite bearing, I think; and the direct expensing is almost necessary for a small business, I believe. So I'd hate to see anything happen to that, is my opinion.

Mr. Freeman. I would agree with that.

Senator Sasser. Is that the consensus here?

Mr. Bateman. That's right.

Senator Sasser. Well, let me ask you this question. Would it be a significant incentive if we went ahead and raised the direct expensing limitation from $5,000 to $10,000?

Mr. Freeman. Yes, sir.

Mr. Bateman. Yes, sir.

Mr. Oldham. Absolutely.

Mr. Bateman. Senator, thinking back about Jane Jone's testimony, you know, that's a tremendous testimony on her part to talk about how she was able to start with $1,000 and start her company, and yet she gives credit to the new jobs credit, investment tax credit, and accelerated depreciation as an incentive on her part to continue her business, you know, with a limited capital base. And if my clients have any problem, Senator, it's accumulating enough capital to get started. So anything that is detrimental to a company starting with a limited capital base, I'm against it. I'm opposed to it.

Mr. Oldham. Senator, I'd like to make one other point. You mentioned earlier to some of the earlier witnesses that some of the arguments against the ITC were that the people who had mostly labor as opposed to capital investment, they said it was favoring them. Well, instead of taking a negative approach, which it sounds to me like someone has done, and saying, "Let's do away with the ITC," they should take a positive approach and say, "What can we do for these people over here who are labor intensive in order to help them to get some breaks as the ITC does, and people that spend capital do?"

Senator Sasser. Well, I think that's a point well made, and I appreciate very much you bringing that up.

Gentlemen, thank you very much for appearing here today. This serves a very valuable purpose because the testimony that we've taken here today will be reviewed, and it will be part of the hearing record of the Small Business Committee. This hearing record will give us a frame of reference, when we start looking at tax reform legislation and making a determination as to what type of impact it's going to have on small business. And the only way we can roughly determine this impact is to talk to people down where the rubber meets the road, and that's talking to small business people themselves and getting their views. Obviously we don't have a unanimity of views today on this tax reform proposal. That's one of the problems that we have in Government. There's hardly ever a unanimity of views, and certainly never a unanimity of views when you're talking about taxes. Nobody likes to pay taxes and everybody would like to see somebody else pay the taxes.

But my concern here is trying to maintain a tax structure that will be encouraging to small business because, as I said in my opening statement, small business is the innovator in this country. And as Wayne Oldham said, small business is the one that's increased creative jobs here over the past decade and a half; it's not the Fortune 100 companies, it's small business. Small business is where the genius of American entrepreneurship now resides. Small business is having a tough time. In my judgment, we've got to make absolutely sure that any changes in the Tax Code will not be overly restrictive on small business thereby snuffing out many encouraging new businesses.

Let me conclude by again expressing my thanks and gratitude to all of you for taking time from your busy schedules and coming here today. It's been very helpful. If you have any additional ideas or comments, please feel free to submit them and we can incorporate them in the record; or if you want to give them to me confidentially, just pick up the phone and give me a call. I'd be delighted to hear from you.

Mr. **Oldham**. Thank you, Senator.

Mr. **Freeman**. Thank you, Senator.

Mr. **Bateman**. Thank you, Senator.

[Whereupon, at 11:14 a.m., the committee recessed, to reconvene at 2:30 p.m. at room 309, Moot Court Room, Memphis State University Law School, Memphis, TN.]

AFTERNOON SESSION

Memphis, TN.

Senator **Sasser**. The hearing will come to order, and I'd like to open these hearings here this afternoon by welcoming all of our witnesses and observers here from the small business community. I know that time is money in small business, so we thank you very much for your time here.

I have an extensive statement prepared for the hearing record which I will insert in its entirety, for now my primary interest is hearing the remarks of our witnesses on this very important subject.

The Senate Small Business Committee, under the direction of Senator Lowell Weicker, our chairman from Connecticut, and Senator Dale Bumpers, the ranking minority member from Arkansas, will be holding a series of field hearings all across the United States exploring the impact of the Treasury Department's tax reform proposal on the small business community. Today's hearing marks the first step in that process. I am pleased that we're able to have the leadoff hearings for this nationwide series here in Tennessee where small business is so central to the economic well-being of our State.

Let me give you some statistics that I think you'll find very interesting. There are some 83,000 business establishments in the State of Tennessee. Of these, 79,000 have less than 100 employees, so they qualify as small businesses; and over 58,000 of these small businesses employ less than 10 people.

These small firms produced roughly one-half of Tennessee's $50 billion in goods and services in 1982. Small business makes up 99 percent of the construction firms in Tennessee, 98 percent of the service operations, 99 percent of the finance, insurance, and real estate businesses, 80 percent of our manufacturing concerns, and 61 percent of the State's wholesale and retail operations. So it's very clear that small business is, indeed, big business here in the State of Tennessee.

Now, these small firms share in the growing interest in tax reform that's spreading across the country and have much to add to the debate on this particular subject. Many of you here today, will agree that our present tax structure is simply too complex. It's inefficient, and it's full of loopholes. You also will likely contend that small business pays more than its fair share of taxes. I haven't talked to a taxpayer yet that doesn't feel that he or she or their company is probably paying more than their fair share of taxes; sometimes I feel that way myself. But over 41 percent of the respondents in a recent tax survey said small business pays too much in taxes. Over two-thirds of those who responded to that survey said that large corporations and large companies pay less than their fair share of taxes.

Well, there's good reason for this point of view. The Joint Economic Committee of the Congress issued a report late in 1984 showing that the corporate share of the Federal tax burden was only 6.2 percent in 1983, down from 17 percent in 1970. Individual tax returns, on the other hand, accounted for 48 percent of all Federal receipts.

The tax reform proposals under consideration in Congress attempt to balance this burden of taxation a little more evenly. Indeed, the Treasury Department proposal, the focus of our hearings, relies greatly on increased corporate taxation to make up revenue lost through individual tax cuts. We all applaud the efforts to restore a greater sense of equity to our tax system. But we must make sure that we know the full impact of tax reform proposals before implementing those programs. This is especially true in the small business community. To date there has been little to no dialogue on the consequences of tax reform for small business. These hearings help rectify this omission. The Senate Small Businesss Committee is going to the country to ask the small business people here in Tennessee and all across the country on where we need to put our emphasis should a tax reform bill move through Congress. And you can help to do that by giving us your views here, where the rubber meets the road. It's here in Memphis and in Nashville and other cities across the length and breadth of this country, that small business people can give us practical insight into what's working, what's not working, what ought to be kept, and what ought to be changed.

So with that, let me again thank you for for taking time out from your schedule to be with us today. Our first witness is Dr. Leonard Rosser, the director of the Tennessee Small Business Development Center here at Memphis State University. We're delighted to see Dr. Rosser and he'll be accompanied by Ed Cole, also of the Small Business Development Center here in Memphis, TN.

Dr. Rosser, would you and Mr. Cole come forward.

Dr. ROSSER. I have also Dr. Stallings here for the same panel.

Senator SASSER. We'd be delighted to have him.

STATEMENT OF DR. LEONARD ROSSER, DIRECTOR, TENNESSEE SMALL BUSINESS DEVELOPMENT CENTER, MEMPHIS STATE UNIVERSITY, ACCOMPANIED BY EDGAR R. COLE, SMALL BUSINESS DEVELOPMENT CENTER, MEMPHIS, TN; AND DR. BILLY G. STALLINGS, VICE PRESIDENT AND TREASURER, ECS INDUSTRIES

Dr. ROSSER. Mr. Chairman, members and staff of the Senate Small Business Committee and Senator Sasser's office, let me first welcome you to Memphis in your continuing efforts to assist small businesses. Your interest and support of small businesses has long been known to all your constituents in Tennessee, as well as your recognition that small business created and developed the economic wealth of this Nation.

Like you, I have prepared some remarks that I have submitted for the record; I will not attempt to cover all of these at this point. I wish to share my time before this committee with my two colleagues here.

Even though many small businesses such as the Ford Motor Co. and other giants of industry have left the ranks of small business, small business still means jobs. It still provides the economic foundation, the wealth, and the capital formation of this great Nation. Small businesses still grow into big businesses and add further wealth and further jobs to our economy. However, it is the small business which best survives recessions and maintains employment levels during those recessions. It is the innovation of small business, from the cotton gin to the modern-day high-tech microchips that undergirds this Nation. Capital formation and economic development are two concepts which are based in small business. I'm not a tax expert, nor am I an economist, but I am a strong advocate of small business; therefore, I wish to make these few comments, then yield the floor to be shared with these other two. My prepared remarks, as I said, are before you for review.

Dr. Billy Stallings is a certified public accountant but earns his living as a small businessman. He is the vice president and treasurer of ECS, Inc. and owns or has ownership holdings in several other companies. He is considered to be knowledgeable in small business taxes.

The other person is Mr. Edgar Cole, director, Southwest Tennessee Regional Small Business Development Center. Mr. Cole is a former executive of Exxon and is now totally involved with small business in the 13 counties making up his region of this Tennessee Small Business Development Center.

The remarks and testimony of all three of us are individual views and they are in no way to be considered the views or the position of Memphis State University, of which we are representatives (but not at this particular format).

I wish to, if I may, make just a few short comments before I yield the floor to what I initially said. I'm not an economist or a tax expert. I have done some research in the area and I've submitted that in the statements that I have here.

Senator SASSER. We've listened to some of the tax experts, Dr. Rosser; they've gotten us in some of the problems that we're in now. [General laughter.]

Dr. ROSSER. I think I'm trying to get you out of some of those tax experts with this testimony and my urging of you at this particular hearing.

I am a strong advocate of small business. I do support tax reform and simplification, a tax system that has three basic goals, in my opinion: the goals of equity, efficiency, and simplicity. Any tax system, to be effective, should contain those three things. I need not further discuss these particular goals except to say that in my opinion our present tax system does neither of these three things. It appears to favor the wealthy individual, as you had earlier commented, and the large corporations who can afford to take advantage of the alternatives that are provided in our present tax system. The small businessperson, either by size, lack of earnings, or sales, cannot take full advantage of all those alternatives and if they could, they couldn't afford to do it because of lack of profits to do it.

I am concerned, even though in favor of all these reforms and simplifications, I am concerned with the one-level 33-percent tax proposal for all corporations. It appears to further shift taxes to those small businesses least able to generate the capital formation and retention that is needed to perpetuate their livelihood. A greater share of relative cash flow will go for taxes. Perhaps alternatives to the one flat tax rate should be considered, such as, perhaps, three levels of flat taxes——

Senator SASSER. With the so-called tiered approach?

Dr. ROSSER. A tiered approach, perhaps two or three levels, that whether the flat tax for the small, entrepreneurial corporation with before tax earnings of less than $50,000 or $75,000 being taxed at some more favorable rate than 33 percent, which is the same rate at which the huge corporation is taxed. If the 33 percent comes out of an after tax profit of $25,000 versus 33 percent of after tax profit of $1 million, there's considerable disparity between what's left over to invite capital formation, reinvestment, and moving on.

These small businesses cannot take advantage, in many cases, of the tax credit provision that is now there, that is proposed to be deleted. It does not favor them as much as it does the large corporations. They cannot use to full advantage the depreciation or depletion that is there now. Testimony or statistics are in my report alluding to this or supporting it.

They cannot do it simply because they are people-intensive or labor-intensive, not capital- or fixed asset-intensive. Perhaps the service organizations or distribution centers, this type of thing, cannot take those advantages; therefore, I think that perhaps an alternative could be looked at that would give them some advantage to retain what they've earned.

The dictionary—I don't want to get too academic here—the dictionary defines an entrepreneur as "a person who organizes and manages a business undertaking, assuming the risk for the sake of profit." This Nation's business is entrepreneuric work. I urge you to beware, the entire committee: Do not fall prey to large corporate pressures, to theoretical approaches, to idealism's effects, or to political expediency in making these reforms that we all feel are necessary. Do not reform and simplify entrepreneurs out of the opportunity to be an entrepreneur, to generate his or her own working and expansion capital from operations and after tax profits.

These are the things that bother me about the simplification or the flat tax rate that we have in this. I would like to see much more work done in trying to see exactly where this fits into the overall tax structure as well as benefiting the small businesses who, in your words, make up 98 or 99 percent of the businesses in Tennessee anyway. We need that help. I know you are of the same persuasion as I am, or otherwise you would not be holding these field hearings to seek the opinions and advice of the grassroots level. There are many learned people who will give you many learned reports that are based on the theory of what is best rather than the practice of what is best. This is the reason I have invited Dr. Stallings and Mr. Cole to be with me this afternoon.

I would now like to yield some of my remaining time to Dr. Stallings, the practicing businessman.

Senator **Sasser**. Thank you. We are delighted to have you, Dr. Stallings, and you just go right ahead.

Dr. **Stallings**. Let me welcome you home and thank you for coming down and listening to our problems.

Senator **Sasser**. Thank you.

Dr. **Stallings**. We've got a lot of them. We've got lots of problems.

You know, I'm sort of reminded that small business today is sort of like grandma's cookies at the family reunion. Everybody goes by and gets one or two—nobody's a hog—but at the end of the day, they're all gone. And we're nibbling at small businesses today with just the same thing. We've got taxes, regulation, we've got EPA, FDA, OSHA, MESA, and all those I can't even remember, and the paperwork, imports, interest rates, everything in the world is stacked against the small businessman.

The major thrust of my testimony today, though, will deal with cash flow, the cash flow problems of small businesses, and the effect of these current proposed changes in the Federal tax laws upon the cash flow of businesses.

I visited the Tennessee Small Business Development Center just yesterday, and the sign in the entrance over there, supplied by your Small Business Administration, I think, said "Small Business Means Jobs." I think that's very true, and the statistics you gave us further emphasize that. If we don't have small businesses we're not going to have many jobs around here.

Fourteen years ago the company I'm with today, ECS Industries, secured an SBA 502 loan with the assistance of the Regional Economic Development Center here at Memphis State, started a brand new company at Gallaway, TN, in a cornfield; nothing there before. Today, we—last year it was approximately $10 million in annual sales and almost 100 employees where there was nothing, with the assistance of SBA, Memphis State, and all the other regional economic development center sponsored by SBA.

In addition to this, I have consulted with many, many companies through the SBIC program sponsored by Small Business Administration in conjunction with Memphis State students and SCORE and other representatives. Been in any number of these. The bottom line in all of these is cash flow; that's it, raising enough money to expand and "stay alive."

There are four areas that I'd like to comment on today. One is the investment tax credit, accelerated cost recovery system and elections to expense business property. These are all intertwined in this one category. Another is the income tax rate for corporations. Something has been mentioned on that already, but I'll comment very briefly on that. The other is Federal Income Contribution Act and Federal withholding taxes. You've probably heard it before, but I'm going to say it again unless you gavel me out, company vehicles and logging procedures.

Senator SASSER. Yes, we've heard that before.

Dr. STALLINGS. I'll bet you've heard it. [General laughter.]

Most small businesses don't have access to the same equity capital markets that large companies have. They rely on the protection afforded by investment tax credit and fast writeoff of assets, ignoring their so-called economic life. That's where they get their money. That's where the working capital comes from. The proposal to repeal this Investment Tax Credit and to equate depreciation with an approximate economic life, longer life, less writeoff, more taxes, less cash is disastrous to small companies. It will rob them of what little cash they have right now. It's just something I don't think they can handle.

Federal income tax for corporations—under the current law, corporations are taxed more favorably on the first $100,000. As I read the proposals now, we're looking at a flat 33-percent tax on all income of corporations. The corporation that earns $25,000—and remember, corporations are small businesses, too; most of them are. Most of the corporations I know do not earn $150,000. If a corporation earns $25,000 today, it pays $3,750 in taxes. Under the new regulations it would pay $8,250, an increase of $4,500, over 100 percent more. The corporation has to get to approximately $150,000 or $160,000 of before tax income before there's a break-even situation. Anybody earning under $150,000 is penalized severely. Over that, they probably don't need the help anyway. I'm partial to small businesses.

Federal Insurance Contribution Act and Federal withholding taxes—7.05 percent on the first $39,600 is a significant cost of adding one new employee to the payroll. It's burdensome. Most small firms don't have trained professionals or computers for the existing payroll recordkeeping requirements, let alone others we're trying to add based on fringes. We start trying to tax withholding—or to compute withholding—taxes from fringes, it's going to be a nightmare. Right now, the current regulations require payroll related recordkeeping for gross pay; sick pay; bonuses; commissions; tips; interest; pension and profit sharing; auto deemed compensation; excess life insurance; FICA; withholding tax, State, city, and Federal; State, city, and Federal unemployment, and workmens' compensation. We start adding on things like excess group life insurance and meals that might be more than some average amount, it's just a nightmare for a small business. We can't do what we're asked to do now; if they ask us to do more, it's going to be tough.

Company vehicles—I don't think anyone finds fault with restrictions on luxury automobiles. I don't think that's a problem. I think small businesses probably welcomed it because they can't drive a Mercedes themselves, you know, "go tax those Mercedes"—it doesn't matter to them. But right now there is a presumption that every mile driven is a personal use mile unless an entry is made on a log. There's that assumption; it's personal use unless you log it. It's probably very trite, but I just made a simple calculation here. If a truck driver, delivering eyeglasses or beef, makes 20 stops a day and takes only 1 minute to make an entry in his log, and at the end of the day 10 minutes to even it up, beginning and ending computations, that's 6 percent of his productive day that has gone to recordkeeping for automobiles. That's too much. That's too much.

It appears to me that current tax law is spewing from "think tanks" run by extremely bright, theoretically correct, and well-intentioned scholars who have never managed any business more complex than their individual checkbooks.

I pray that you don't kill this American economic golden goose. Small business needs more help, not less.

And I thank you.

Senator SASSER. Thank you, Dr. Stallings.

Mr. Cole, do you want to add to the comments today?

Mr. COLE. Senator Sasser, I appreciate it very much, and also appreciate the fact that I have worked for a large corporation prior to coming to work for——

Senator SASSER. Exxon, one of the largest; I understand that.

Dr. ROSSER. He knows both sides of the story. [General laughter.]

Senator SASSER. He knows both sides.

Mr. COLE. So I feel that I'm fortunate from that standpoint.

What I'd like to do is talk from the position of what I've seen with the clients we've had, so with that in mind I'd like to position ourselves.

First, the southwest region of the Tennessee Small Business Development Center consists of 13 counties with some 16,000 businesses with less than 100 employees. This is about 25 percent of the 79,000 small businesses in Tennessee that you mentioned earlier. In our first 10 months of operations, owners and chief executive officers of over 500 businesses in Tennessee, of which 250—or 50 percent—within the southwest region have requested assistance or counseling help to establish or to make their ongoing business profitable.

The majority of these existing businesses that we have as clients are not considered to be successful at this time. Many of them have been at the point of failure when our counseling was requested. Survival, and not taxes, is their primary concern at this time.

However, thinking in terms of them, my comments are based on the information I received from these clients. While my comments will not totally be representative of successful small businesses, there are similar situations which apparently affect all small businesses. It is with that in mind that I want to make my comments.

When we analyze our small business clients and consider the causes of their problems, several facts come to light. The small business fails because of the obvious lack of poor management, lack of a business plan and objectives, poor location, substandard product or service, et cetera. Underlying this entire problem, however, all of these facts, is a need for money to pay employees, other expenses, and to grow. In many instances the owner has less income than employees.

Our center, which was funded and structured to help small businesses succeed, can provide the advice and help with a business plan on a business that we believe is viable. However, we provide no funding for facilities, equipment, and working capital. I have the following two comments on this.

With regard to financing—Dr. Stallings, I think, touched on this earlier—a small business cannot readily obtain a small loan. It appears that the financial community will view a small business as a large corporation, and financing is approved only if the small business is quite strong and has adequate collateral. Most do not have adequate collateral.

In the case of taxes, again, the small business appears to be viewed as a large corporation. If it has one employee it is required to keep records and comply with the tax laws as if it were a multifunction corporate giant. The owner cannot be totally effective in running the business and make it profitable if he has to handle the accounting and bookkeeping and assure he is complying with all the laws.

I believe every small business wants to be profitable so it can add jobs and grow. Small business needs your help in this regard.

From a tax standpoint, I feel they need the following, at least. They need a recordkeeping and reporting system for tax purposes that a small business owner can use without hiring outside assistance to complete it. They cannot do that today. He needs information to be able to retain those expenses and credits that are now allowed which helps him to get started and to grow. The laws that he has to go by have to be more easily understood, and they are not today for the business owner who, in many cases, has nothing more than maybe a high school education; tax laws that are not so simple, however, that they will adversely affect the small business and lead to a reduction in the number of small businesses.

And finally, a tax law that will not stifle business growth or penalize a small business for making a profit. Now, let me comment on that, if I may.

In my judgment, the flat corporate tax rate proposed adversely affects a small business. Our successful clients show a net profit generally of less than $50,000, and we do have a few successful clients at this time. A small business with a $50,000 profit will pay some $9,000 more in taxes in the future with the 33-percent flat tax rate. We need a law that recognizes the extent to which a small business must produce its own money to expand and grow. It needs to retain profits in the good years for cash flow in the growth years and when the lean years occur. It does not have the financial flexibility of a large corporation; it cannot go out and borrow and get the money when it needs it in all cases.

To help the small business—and I'll make a suggestion here; again, don't run me off for making a suggestion, but I think it illustrates what I'm trying to say—to help the small business, I suggest eliminating the corporate income tax when the net profit is $50,000 or less. An alternate would be the retention of a portion of the tax money from those under $50,000 net profit corporations to be used as needed by small businesses for growth and in the lean years.

It may be difficult to administer such a program; however, this is suggested to emphasize the fact that small corporations with a low net profit need separate tax considerations from the large corporations.

I appreciate the opportunity to make my comments.

Senator SASSER. Thank you, Mr. Cole.

[The prepared statements of Dr. Rosser, Dr. Stallings, and Mr. Cole follow:]

REMARKS ON THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

made to the

SENATE SMALL BUSINESS COMMITTEE

FIELD HEARING HELD AT

MEMPHIS STATE UNIVERSITY LAW SCHOOL

JANUARY 9, 1985

BY DR. LEONARD ROSSER, STATE DIRECTOR

TENNESSEE SMALL BUSINESS DEVELOPMENT CENTER

Mr. Chairman, members and staff of the Senate Small Business Committee and Senator Sasser's Office:

Let me first welcome you to Memphis, Tennessee in your continuing efforts to assist small businesses. Your interest and support of small business has long been known as well as your recognition that small business created and developed the economic wealth of this nation.

Even though many small businesses such as the Ford Motor Company and other giants of industry have left the ranks of small business, small business still means jobs and still provides the economic foundation, wealth and capital formation of this great nation. Small businesses still grow into big businesses and add further wealth and jobs, however; it is the small business which best survives recessions and maintains employment levels. It is the innovation of small business, from the cotton gin to modern day high-tech micro chips that undergirds this nation. Capital formation and economic development are two concepts which are based in small business. I am not a tax expert nor am I an economist. I am a strong advocate of small business. Therefore, I wish to make a few comments then yield my floor time to be shared by two others. My prepared remarks are before you for review and consideration.

Dr. Billy Stallings is a Certified Public Accountant but earns his living as a small business man. He is Vice President and Treasurer of ECS, Inc. and owns or has ownership holdings in several other companies. He is considered to be knowledgable in small business taxes. The other person is Mr. Edgar Cole, Director, Southwest Tennessee Regional Small Business Development Center. Mr. Cole is a former executive of Exxon and is now totally involved with small businesses in the thirteen counties making up his region of the TSBDC.

The remarks and testimony by all three of us are individual's views and in no way are to be considered the views or positions of Memphis State University.

Fundamental tax reform has become an important economic and political issue. Many policymakers believe that the current system of federal income taxation no longer can generate enough revenue to meet the country's budgetary needs. The existing system is also viewed as a disincentive to investment, savings and work in ways that alter patterns of economic activity and the allocation of resources. Finally, there is a growing public dissatisfaction with a system viewed as complex, unfair and partial to sepcial interest groups and the wealthy.

Previous efforts at reform have not resulted in a basic reevaluation of the tax system but have created a checkerboard of confusing provisions which demand fundamental reform.

Fundamental tax reform is vital to small business and will involve both benefits and costs for the small business community.[1] Lower marginal rates and simplified tax system will make it easier for small businesses to successfully use such a system. At the same time, the proposed broadening the tax base will require reducing or eliminating certain preferences in current law that were created to achieve certain economic or social goals. Consequently, certain benefits under the current system will no longer be available to small businesses, such as the proposed replacing the Accelerated Cost Recovery System (ACRS) with a slower depreciation system and the direct expensing of all or a portion of equipment costs.

There are three underlying reasons for fundamental tax reform.

> First, the current tax system apparently no longer meets the revenue needs of the Federal Government; tinkering with the existing system does not seem a viable way to meet those needs. Continuing executive and congressional inability to deal with high deficits underscores this problem and provides a strong motive for reform.
>
> Second, there is general agreement that the present tax system suffers from structural defects that discourage savings and investment. This results

in the misallocation of resources and the restraint of economic growth and capital formation. A basic defect in the current system is the existing narrow tax base that requires high marginal rates on taxable income, which reduces the incentive for work and income generating activity. This is especially relevant to small businesses operating as sole proprietorships or partnerships, the income of which is taxed directly to individuals.

Another basic structural defect in the current tax system is how income from capital is taxed. There are numerous tax preferences for both individuals and corporations that inappropriately skew economic choices and result in the inefficient allocation of economic resources. The result is a great disparity in how capital income from different sectors of the economy is treated. Under the current system, the tax treatment of income from capital (rents, interest, profits or dividends) is inconsistent with the tax treatment of the interest cost of funds borrowed to purchase capital assets; this leads to investments made solely to take advantage of the tax system and results in the misallocation of economic resources.[2]

The current system also suffers from the "double taxation" problem that leads to economic distortions and misallocation of resources.

First there is double taxation of savings. Savings are available only after the payment of taxes. Earnings on these savings are taxed again resulting in double taxation, which clearly acts as a disincentive to savings and investment. While numerous devices -- such as special treatment for capital gains, the investment tax credit, deferral on certain types of investment, and various forms of accelerated depreciation--are utilized to reduce the adverse impact of this problem, the distortions and disincentives and resulting misallocations remain.[3]

The second area of double taxation derives from the interaction of the corporate and individual income taxes. Under the current tax system, corporate earnings are taxed twice. They are first subject to the corporate income tax and then taxed again as income to shareholders when dividend distributions are made. Earnings which remain undistributed are taxed to shareholders only if they raise the value of the stock and only when and if the stock is sold. While this taxation is at lower capital gains rates, double taxation still results.[4]

The separate corporate income tax raises several economic problems. It increases the final tax rate on earnings from investment in corporations and inhibits investment as well as savings. The separate corporate income tax also restricts the flow of capital to corporations as compared to other more tax-advantaged investments. In addition, this double taxation encourages the use of debt over equity as the primary basis of corporate financing. The differences in the tax treatment of dividends and retained earnings discourage the distribution of earnings, which also inhibits and distorts investment.[5]

A third major reason for the proposed overhaul of the current tax system stems from the growing dissatisfaction of the American public, which often views the present system as complex and favoring the wealthy and special interest groups. Inflation exacerbates this perception by placing individual taxpayers in higher tax brackets without increasing their real income. As a consequence, taxpayers are forced to seek all possible tax preferences to reduce their tax burden.

SMALL BUSINESS CONSIDERATIONS AND THE CURRENT TAX SYSTEM - The impetus for fundamental tax reform reflects small business concerns and underscores the need for such reform. The current income tax system is a hodgepodge of conflicting provisions that are difficult for small businesses to understand and use.

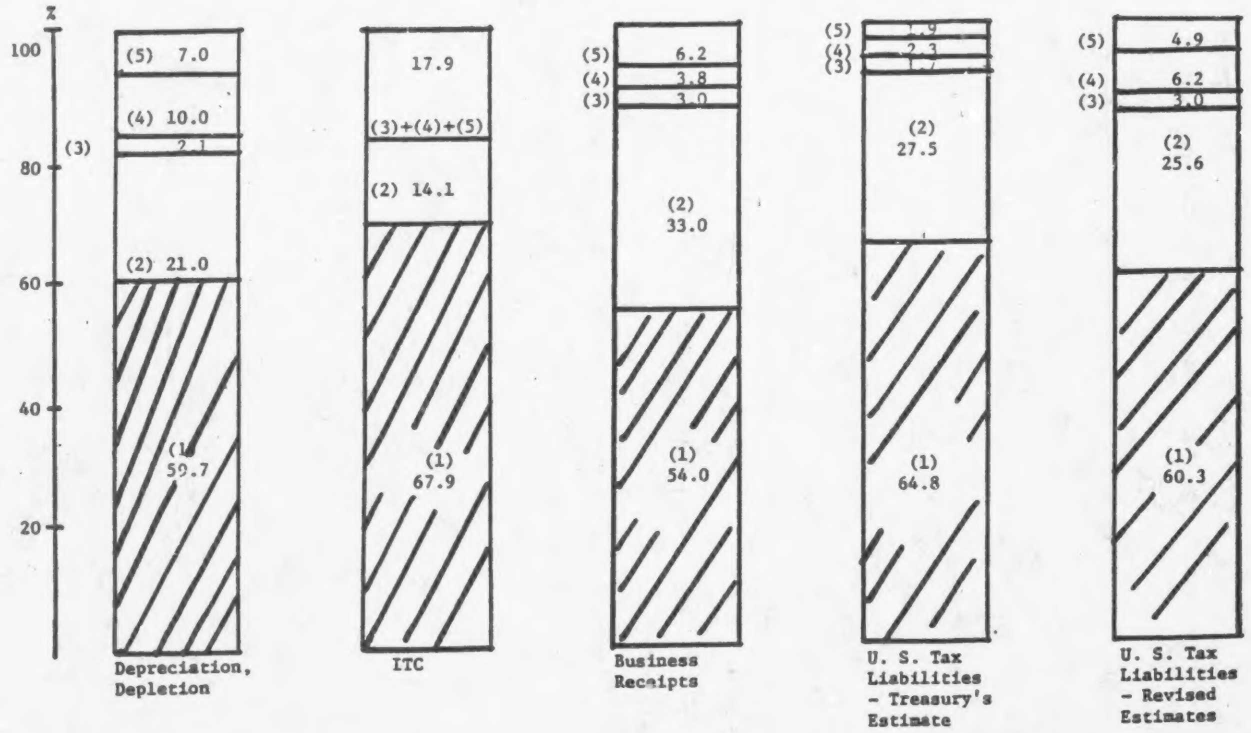
The business and investment provisions of the existing system can be classified by how they relate to capital formation and retention. Provisions that relate to capital retention have an impact on a business' ability to retain what it earns and use it as a source of internally generated financing for operations and expansion. These provisions are important to firms in their start-up phase. Provisions relating to capital formation are those that affect a business' ability to obtain capital from external sources and are especially important to small businesses during their early development.

Tax rate changes, depreciation and the investment tax credit affect capital retention by businesses. The favored treatment for capital gains is perhaps the clearest example of a provision relating to capital formation.

A recent study conducted for the Small Business Administration, Taxes, Financial Policy and Firm Size, Ted E. Day, Hans R. Stoll, and Robert E. Whaley of the Owen Graduate School of Management at Vanderbilt University, concluded that small firms benefit less from tax deductions and credits than do large firms.[6] Table 1 shows small and large business shares of business receipts, depreciation, investment tax credit and tax liabilities for non-agricultural industry. Table 2 amplifies this comparison on an industry-by-industry basis. This in turn means that the existing tax system does not allow small businesses to retain capital as efficiently as large firms.

TABLE 1

Small and Large Business Shares of Business Receipts, Depreciation Allowance, Investment Tax Credit, and Tax Liabilities for Non-Agricultural Industry, 1980



This table shows that large differences exist among different industries in the shares in revenue, depreciation, etc.

(1) For depreciation, small corporations in agriculture, mining, and fire have shares relatively larger than revenue shares while larger firms accounted for large shares in depreciation in manufacturing, transportation and utilities, and service.

(2) For ITC --- Large firms have much larger shares in manufacturing, transportation trade, and service.

(3) Total tax credit include foreign tax credit which is affected by tax paid to foreign government. It is, therefore, difficult to interpret the meaning of the computed share.

Note: (1)------- Large corporations, with assets of $25 million and over.
(2)------- Small corporations, with assets of less than $25 million.
(3)------- Sub-S corporations
(4)------- Partners
(5)------- Sole proprietors

Note 2: U. S. Tax Liabilities for sole proprietors, partners, and Sub-C corporations are not available in IRS's report. Estimates were made by U. S. Treasury. See "Report of the Treasury Department," *U. S. Small Business Administration Annual Report, FY 1980* Tables 1 and 2. Revised estimates (column 5) were made by applying a 50% to net income figures for business income. Treasury uses 25% in the estimation, with remaining 75% as labor income for owners.

Source: Computed from U. S. Treasury, Internal Revenue Service, Statistics of Income, 1989-80 *Sole Proprietorship Returns*, *1980 Corporation Income Tax Returns*, *1980 Partnership Returns*, (Washington, D.C.: Government Printing Office) and U. S. Small Business Administration, *Annual Report for FY 1980* (Washington, D.C.: Government Printing Office).

TABLE 2
Small and Large Corporations Share Revenue, Depreciation Allowance, Investment Tax Credit, and Tax Liabilities by Industry, 1979 (Percent)

	Gross Revenue	Depreciation Etc.	Investment Tax Credit	Total Tax Credit	U.S. Tax Liabilities	World Tax Liabilities
Agriculture						
Small	75.1	86.3	81.0	74.9	64.6	62.2
Large	14.2	6.4	16.9	17.3	21.6	24.4
Mining						
Small	13.1	24.4	25.4	0.4	21.4	1.3
Large	85.8	72.5	70.6	99.4	71.5	90.2
Construction						
Small	75.6	73.2	74.7	63.3	66.0	60.3
Large	24.0	26.5	24.9	36.2	33.6	39.3
Manufactures						
Small	15.3	10.8	8.6	4.4	12.3	4.6
Large	84.2	88.9	91.2	95.4	87.2	91.0
Transportation and Public Utilities						
Small	14.1	8.4	5.0	5.4	10.0	9.4
Large	85.3	91.3	94.9	94.5	89.6	90.1
Wholesale and Retail						
Small	54.6	54.3	43.5	33.5	46.1	42.6
Large	44.5	44.9	56.0	66.2	52.7	56.3
Fire						
Small	10.4	24.8	10-.1	5.4	14.1	12.4
Large	87.2	72.9	89.6	94.1	84.7	86.4
Service						
Small	74.4	56.9	53.5	54.6	46.4	44.3
Large	24.7	41.9	45.7	44.4	51.6	53.7

Note: Small corporations are those with assets of less than 10 million. Zero asset-size group has been excluded from small size group. Consequently, components do not add up to total.

Source: Computed from "Rates of Return and Arrange Tax Rates By Firm Size and Industry," a progress under SBA Contract 7196-OA083.

The study bases its conclusion on several factors. First, small firms have lower statutory tax rates than larger firms and, therefore, have lower marginal tax benefits from deductions. Second, small firms have greater variability of income than large firms and, hence, have a greater probability of not having sufficient income against which to take deductions. Third, small firms tend to take proportionately less of the tentative investment tax credit than large firms and are less likely to have sufficient income to use the available tax credit. Finally, small firms appear to have a larger fraction of cash flow taken as depreciation and are likely to benefit less from further acceleration in depreciation. The initial findings of a study being completed for the Small Business Administration by Jack Faucett Associates on the effects of the 1981 and 1982 tax acts on small and large firms supports these conclusions.[7]

Besides the problems created by different marginal rates between large and small business, the relatively high individual marginal rates of the existing system inhibit small business' capital formation and retention. This is crucial to small firms that operate as sole proprietorships or partnerships (or S Corporations) where income is based directly to individuals. (See Table 3 for a breakdown of businesses by type of entity.)

The structural defects of the existing system, with its resulting double taxation of savings and corporate profits, also discourage capital formation and growth for small businesses. Furthermore, because many small firms are labor intensive rather than capital intensive, the tax incentives for capital investment built into the system are not as relevant to those small firms.

These defects add to the small business community's perception of the unfairness of the existing tax system. This perveived inequity is magnified by the sheer complexity of the tax laws that make the system virtually unworkable for small businesses. Consequently, fundamental tax reform would greatly benefit small business.

Again I repeat that I am a strong advocate of small business. I do support tax reform and simplification; a tax system that has the three basic goals of equity, efficiency and simplicity. I need not further discuss these goals except to say that in my opinion our present tax system does neither. It appears to favor the wealthy individual and large corporations who can afford to take advantage of the altenatives provided.

I am concerned with the one level 33% flat tax proposal for all corporations. It appears to further shift taxes to those small firms least able to generate capital formation and retention. A greater share of relative cash flow will go for taxes. Perhaps alternatives to the one flat tax rate should be considered such as three levels of flat rates with the small entreprenual corporation with before-tax earnings of less than $50,000 being taxed at some more favorable rate such as 16 percent of earnings.

The dictionary defines an entreprenuer as " a person who organizes and manages a business undertaking, assuming the risk for the sake of the profit". This nation's business is the entreprenuer at work. I urge you to be wary. Do not fall prey to large corporate pressures or political expediency. Do not reform and simplify entreprenuers out of the opportunity to be an entreprenuer, to generate his or her own working and expansion capital from operations and after-tax profits.

I know you are of the same persuasion, or you would not be holding field hearings to seek the opinions and advice at the grass roots.

Now, I yield and introduce Dr. Stallings.

FOOTNOTES

[1] This portion is almost verbatim from TAX REFORM, Economic Policies in the Eighties: The Small Business Factor published June, 1984 by the Office of the Chief Counsel for Advocacy, U.S. Small Business Administration.

[2] In an examination of this structural deficiency see Harvey Galper, The Coming Reexamination of Tax Policy, Tax Notes, Volume XIX No. 5, Washington, D. C., May 2, 1983, pp. 379 at 382 - 284, reprinted from Setting National Priorities: The 1984 Budget, Joseph A. Pechman, ed., Brookings Institution, Washington, D. C., 1983.

[3] For a discussion of this problem see Department of Treasury, Blueprints for Basic Tax Reform, Government Printing Office, Washington, D. C. , 1977, pp. 23.

[4] Ibid, pg. 68.

[5] Ibid, pg. 69.

[6] Ted E. Day, Hans R. Stoll, Robert E. Whaley, Taxes Financial Policy and Firm Size. Washington, D. C., 1984 (report prepared for the Office of Advocacy, United States Small Business Administration (SBA) under award No. SBA 6054-OA-82).

[7] Jack Faucett Associates, Effect of the Investment Tax Credit and the Accelerated Capital Recovery Provisions of the New Tax Law on Small Business Compared to Large, Washington, D. C. (report being prepared for the Office of Advocacy, SBA under award No. SBA 6053-OA-82).

STATEMENT BY

BILLY G. STALLINGS, DBA, CPA

VICE PRESIDENT-TREASURER

ECS INDUSTRIES, INC.

GALLAWAY, TENNESSEE

BEFORE SENATE SMALL BUSINESS COMMITTEE

JANUARY 9, 1985

The major thrust of my testimony deals with the cash flow problems of small businesses and the effect of current and proposed changes in federal taxes upon these cash flows.

I visited the Tennessee Small Business Development Center just yesterday. A sign in the entrance summed up the thoughts of many of us in small business - Small Business Means JOBS.

Fourteen years ago my company, ECS Industries, Inc. at Gallaway, Tennessee secured an SBA 502 loan with assistance from the Regional Economic Development Center at Memphis State University. From small beginnings and 1971 employment of twenty employees, this small company last year had sales of approximately ten million dollars and employed nearly one hundred people.

Over the past six or seven years, I have participated in approximately forty SBIC consulting engagements in conjunction with Memphis State University students and local small businesses. In addition, I have privately consulted and/or been instrumental in the formation of another dozen small companies.

One of the most aggravating problems encountered by these companies was (and still is) that of raising sufficient cash to expand. This lack of working capital is common to the small businesses with which I consult.

There are four areas on which I would like to comment:

1. Investment Tax Credit - Accelerated Cost Recovery System - Election to Expense Business Property.
2. Federal Income Tax Rates for Corporation.
3. Federal Insurance Contribution Act and Federal Withholding Taxes.
4. Company Vehicles and Current Logging Procedures.

INVESTMENT TAX CREDIT-ACCELERATED COST RECOVERY SYSTEM ELECTION TO EXPENSE BUSINESS PROPERTY

Most small businesses do not have access to the same equity capital markets that large companies reach. These companies rely heavily upon the protection from taxes afforded by current investment tax credits and depreciation methods. This protection from taxes is quite often the primary source of "equity" available for the small company.

Proposals to repeal the investment tax credit, to equate tax depreciation with approximate economic depreciation and to eliminate the election to expense $5,000 of business property are now being considered.

The adoption of these proposals will be devastating to the small company! Investment and growth will be extremely difficult to finance without current methods of tax deferral.

FEDERAL INCOME TAX RATES FOR CORPORATIONS

Under current law, corporations are taxed more favorably on the first $100,000 of taxable income. The proposal to change the current rate structure to a flat 33% would be a disaster to the small company with earnings of less than $100,000 as shown below.

Before Tax Income	Tax Based on Current Rates	Tax Based on a Proposed Flat Rate of 33%	Increased (Decreased)
$ 25,000	$ 3,750	$ 8,250	$ 4,500
50,000	8,250	16,500	8,250
75,000	15,750	24,750	9,000
100,000	25,750	33,000	7,250
150,000	48,750	49,500	750
200,000	71,750	66,000	(5,750)
500,000	209,750	165,000	(44,750)

Most of the small businesses that I know earn less than $150,000 before taxes. Rather than a decrease in its Federal Income Tax the small corporation that earns $50,000 has a 100% tax increase.

Every recommendation for individual tax rates proposes a graduated tax. The small corporation needs and deserves this tax break just as much as individuals do.

FEDERAL INSURANCE CONTRIBUTION ACT AND FEDERAL WITHHOLDING TAXES

The current 7.05% contribution rate of FICA taxes on the first $39,600 of earnings is a significant cost of adding new employees to the payroll.

Many small firms do not have trained professionals or computers and existing recordkeeping requirements are difficult enough. New legislation which would impose payroll withholding status on certain fringe benefits will increase the already formidable recordkeeping and reporting requirements of small businesses. Current regulations require payroll related recordkeeping for:

Gross pay
Sick pay
Bonuses
Commissions
Trips
Interest
Pension and/or Profit sharing earnings
Auto use deemed compensation
Excess life insurance
F.I.C.A.
Federal withholding
State withholding
City withholding
Federal unemployment
State unemployment
City unemployment
Workmens Compensation

The next recordkeeping or reporting requirement may be the proverbial straw!

COMPANY VEHICLE AND CURRENT LOGGING PROCEDURES

Certainly no one can find fault with the restrictions imposed on luxury automobiles. Abuses were widespread and I believe small businessmen welcomed this particular aspect of the current vehicle policy.

The real dastardly aspect of the new requlation is the abusive recordkeeping requirements.

There is a presumption that every mile driven is a personal use mile unless an entry is made on a log to substantiate the business use.

If an employee is requested to drive a vehicle home for safe-keeping, that employee is charged with taxable income.

A delivery truck which is used solely for business purposes must be logged. Should a driver be required to log thrity or forty stops a day?

The time necessary to pick up the log, locate and record the odometer reading, calculate the miles driven, enter this data on the log and put the log back will take a minimum of one minute per entry. The salesman or delivery man who makes ten to twenty calls per day and spends ten minutes at the end of the day reconciling individual and total entries has occupied 4% to 6% of his daily effort to totally non-productive time. The log then must be reconciled by someone in the office merely to verify the mathematical accuracy. Current regulations are a nightmare.

It appears to me that current tax law is spewing from "think tanks" run by extremely bright, theoretically correct and well-intentioned scholars who have never managed any business more complex than their individual checkbooks.

I pray that we don't kill America's economic Golden Goose. Small Businesses need more help, not less.

STATEMENT BY

EDGAR R. COLE

DIRECTOR, SOUTHWEST REGION

TENNESSEE SMALL BUSINESS DEVELOPMENT CENTER

FOGELMAN COLLEGE OF BUSINESS & ECONOMICS

MEMPHIS STATE UNIVERSITY

MEMPHIS, TENNESSEE

BEFORE SENATE SMALL BUSINESS COMMITTEE

JANUARY 9, 1985

Mr. Chairman, members of the Senate Small Business Committee and members of Senator Sasser's staff, the Southwest Region of the Tennessee Small Business Development Center consist of 13 Counties with some 16,000 businesses with less than 100 employees. This is about 25% of the 82,000 small businesses in Tennessee. In our first 10 months of operation, owners and CEO's of over 500 businesses in Tennessee of which 250 or 50% were in the Southwest Region have requested assistance or counseling help to establish or to make their on-going business profitable.

The majority of the existing business that we have as clients are not considered to be successful at this time. Many of them have been at the point of failure when our counseling was requested. Survival and not taxes are their concern.

My comments today are based on the information received from these clients. While my comments will not totally be representative of successful small businesses, there are similiar situations that apparently affect all small businesses.

When we analyze our small business clients and consider the causes of their problems, several facts come to light. The small business fails because of the obvious lack of poor management, lack of a business plan and objectives, poor location, substandard product or service, etc. Underlying all of these facts, however, is need for money to pay employees, other expenses and to grow. In many instances the owner has less income than employees.

Our center which was funded and structured to help small businesses succeed can provide the advice and help with a business plan on a business that we believe is viable. However, we provide no funding for facilities, equipment and working capital. I have the following comments on this:

Financing -

A small business cannot readily obtain a small loan. It appears that the financial community view a small business as a large corporation and financing is approved only if the small business is quite strong and has adequate collateral. Most do not have collateral.

Taxes -

Again the small business appears to be viewed as a large corporation. If it has one employee, it is required to keep records and comply with the tax laws as if it were a multi-function corporate giant. The owner cannot be totally effective in running the business and make it profitable if he has to handle the accounting and bookkeeping and assure he is complying with tax laws.

I believe every small business wants to be profitable so it can add jobs and grow. Small Businesses need your help in this regard.

From a tax standpoint they need:

A recordkeeping and reporting system for tax purposes that a small business owner can use without hiring outside assistance.

To retain those expenses and credits now allowed which helps them get started and grow.

More easily understood tax laws.

Tax laws that are not so simple, however, that they will adversely affect a small business and lead to a reduction in the number of small businesses.

A tax law that will not stifle business growth or paralize a small business from making a profit.

In my judgement, the flat corporate tax rate proposed adversely effects a small business. Our successful clients show a net profit generally less than

$50,000. A small business with a $50,000 profit will pay some $9,000 more in taxes in the future with the 33% flat tax rate. We need a tax law that recognizes the extent to which a small business must produce its own money to expand and grow. It needs to retain profits in the good years for cash flow in the growth years and when the lean years occur. It does not have the financial flexibility of a large corporation.

To help the small business, I suggest eliminating the corporate income tax when the net profit is $50,000 or less. An alternative would be the retention of a portion of the tax money from those under $50,000 net profit corporations to be used as needed by small businesses for growth and in the lean years.

It may be difficult to administer such a program. However, this is suggested to emphasize the fact that small corporations with a low net profit need separate tax considerations from the large corporations.

Senator **Sasser**. There are a few questions I'd like to ask here. One, it appears to me, based on what this panel has said, that all of you want to retain the progressive nature of the present corporate tax structure, and you're not much interested in moving toward a flat tax on corporations that would be imposed on small businesses also. Is that a fair assessment?

Dr. **Stallings**. Unless the threshold is such that a small business can survive. We can't have 100 percent increases for small businesses because we're leveling out or averaging the taxes for all corporations. There should be some threshold, and if that's a two-tiered or a three-tiered, yes.

Senator **Sasser**. Do you have any suggestions as to how this tier system should work? Have you thought about that at all?

Dr. **Stallings**. We probably haven't given enough thought to it, but $100,000 is not a lot of money when you start talking about replacing equipment or something like that. It's really not a lot. And I don't know where the $100,000 level came in, but if I remember my tax law, it's probably 25 or 30 years old; and if you look at that on a nonindexed basis, it's certainly not as valuable today as it was at the time it was enacted. So I would think $100,000 is low for a special kind of treatment for small businesses. But I don't have a rate that I could suggest to you.

Senator **Sasser**. Let me ask the panel, what are the typical tax problems that you would deal with in working with clients who come to the Small Business Development Center for help?

Mr. **Cole**. Let me try to answer it this way. I just received a request from a client, and he said taxation—in fact, this was a lady client—"want some viable reductions" or "deductions," is what was stated here. And we do get a number of requests coming in, "we need help on taxes." And yet, when we get into it ourselves in trying to help them in their planning, we find a lot of their problems relate to the fact that they truly don't understand what the laws say. They feel uneasy about it because they don't understand it. And I think perhaps they are concerned that when they have expenses, are they really deductible? And they're depending, in most cases, on outside advice from an accountant that they have or from some accounting firm in an attempt to correct the situation. Since most of the ones that I am dealing with at this point do not show a profit, taxes has not really been a concern to them except for the fact of the paperwork, the recordkeeping, and the handling that they have to do for the payroll taxes and for the taxes for their employees' Social Security and developing and actually sending in the quarterly reports. So that seems to be their concern, and recordkeeping and accounting is, frankly, one of the severe problems for a small business. Recordkeeping and accounting from their standpoint in running the business and knowing the status of it at a certain point in time, as well as recordkeeping and accounting for the tax laws. So that's a concern.

Senator **Sasser**. The Treasury Department maintains that some small business people have a problem in distinguishing between ordinary income and income from capital gains, which I find to be incredible. Is there any validity to that assertion by the Treasury Department? I find it difficult to believe that somebody could be running a small business but not be able to ascertain the difference between ordinary income and capital gains.

Dr. STALLINGS. If you get into the area of section 1231, section 1245, section 1250, probably yes; that's very, very complicated. And there are several dates that determine whether you have capital gains; if it's depreciation in excess of straight line for a period from 1962 to 1982 or something like that. There are some problems there.

I think to carry the problem a little bit further, the companies who are doing fairly well, making a little bit of money and growing, have an even greater problem because they see a profit on the tax return and the accountant tells the guy to pay taxes, but there's no money in the bank because it's in inventory and receivables. So the companies that are having problems are in trouble with cash, but the ones that are doing fairly well have even greater problems. It boils down to cash-flow, and most businesses feel like Uncle Sam is getting a disproportionately larger share of his profit dollar than he deserves at this point.

Senator SASSER. We're talking about small businesses?

Dr. STALLINGS. Yes, sir; small businesses only.

Senator SASSER. All right.

Well, gentlemen, I don't know how much of an opportunity you've had to study the new tax reform proposal that's being advanced by the Treasury Department, but let me ask you this question. Based on what you have been able to learn of it, from the point of view of small business would you favor it or would you feel that you'd have to oppose it? And let me put this caveat on that question. I put the same question to a number of small business witnesses this morning in Nashville, and I came away from there with a feeling that they would oppose the legislation—about two-thirds of them opposed it and one-third of them favored it. So can we reach some unanimity here among this panel, do you think?

Dr. ROSSER. May I approach it from this angle, sir? Mrs. Hudson Federal Expressed the Treasury report to me on Thursday afternoon of last week. Snow prevented it being delivered to me, with the 10 to 13 inches we had. I did get it diverted to Dr. Stallings home—they could get to him—and he spent some time with that over the weekend, and Mr. Cole and I have shared that for 2 days this week. We have not been that far into that particular thing. However, I've been significantly into some other reports, as early as 1982 when this first came up, including a Small Business Advocacy Report of June which I've quoted in my remarks, and a report from a study out of Vanderbilt just recently.

I don't know whether we can reach a consensus or not. I think a part of the lack of consensus is a lack of common understanding. Based upon the Vanderbilt study—as I say, I'm not an economist nor a tax expert—based upon the Vanderbilt study, I do not disagree with what I know about the Treasury Department's proposal on tax reform as much as I disagree with the one level of tax rate——

Senator SASSER. For small businesses?

Dr. ROSSER [continuing]. For small businesses. Now, I'm behind small businesses, because I'm just convinced that it does further invade the rights of small businesses to be able to provide capital formation from operations and profits, even after taxes, as far as that goes; that it hits them more than it does the large corporations. Now, they're already hit, as I had earlier said; they are not able to take advantage of the alternatives in the current tax laws as well as large businesses now. One reason is that their capitalization does not afford them the opportunity, such as the service industries. The other reason is that they do not have the knowledge or the ability of the large corporations to explore those alternatives and take advantage of—if you wish to call it loopholes, fine. They're not big enough to take advantage of loopholes; therefore they're already carrying more than their share. I'm afraid, from what I have seen in that report, that the flat tax rate will further embarrass the small businessman in his ability for capital formation, and therefore, from that standpoint, I'm "anti" the total proposal of the Treasury Department. I think some compromise can be reached that would carry those three basic points I made a while ago. But as it is now, I don't think it does that. That's my personal opinion.

Senator SASSER. Anybody want to add anything to that?

Dr. STALLINGS. We just took a vote and it's 3-0, no. [General laughter.]

Senator SASSER. Three in opposition?

Mr. COLE. We've not had opportunity to study it that much, but nevertheless, from what we see, there's concern——

Senator SASSER. Well, gentlemen, you are going to study it, obviously, in the future. And as you do study it, I'd be interested in getting your further views on it. Now, we're going to hold this hearing record open for at least 3 weeks, and during that period of time if you have any additional thoughts with regard to the Treasury Department, such as how it might be improved, we'd welcome any written communicaton from you that could be added to the record.

Well, I want to thank you, Dr. Rosser and your colleagues, for appearing here today. We appreciate it very much.

We're going to move on to our next panel of witnesses, but we may want to propound some additional questions to you gentlemen in writing; if you'd be kind enough to examine those questions and respond in a timely manner, we'd appreciate it.

Dr. ROSSER. We'd be glad to do what we can.

Senator SASSER. Thank you very much.

All right. Our next witnesses are Mr. Robert Ratton, a distinguished Memphis attorney and tax expert; Mr. Charlie Vergos, the proprietor of Rendezvous Restaurant who is not only a successful small businessman but knows how to prepare delicious ribs; and Mr. B. Lee Mallory of Memphis Compress, the executive vice president of Memphis Compress. Mr. Mallory—yes, sir, B. Lee, if you'd come up here and join us.

Gentlemen, I want to welcome you here today and thank you for taking the time to appear and give us the benefit of your views on the great issues of the day. Your comments will aid us in letting us know whether small businesses think tax reform is a good thing from the standpoint of small business, and if it's not, how it could be improved.

Why don't we begin with B. Lee Mallory? Mr. Mallory, would you share your thoughts with us on this subject?

STATEMENT OF B. LEE MALLORY, EXECUTIVE VICE PRESIDENT, MEMPHIS COMPRESS & STORAGE CO.

Mr. **Mallory**. Thank you, Senator, I'd be happy to and let me add my welcome to you and your staff for coming to Memphis. We've worked hard to get the snow cleared off the runways and the streets cleared for you——

Senator **Sasser**. Well, you did an excellent job.

Mr. **Mallory**. We worked hard at it, too. Two days from now we may be back in the same position.

I'm glad to be here to appear before you and make some comments. We heard your comments earlier about the importance of small business and those of Dr. Rosser, and I think I'm aware of it too since I am a small businessman. Several years ago I had the honor of being the president of the Memphis Area Chamber of Commerce and our objective then, as it still is now at the chamber, was to encourage the growth of industry and jobs in Memphis. We recognized then, as we still recognize today, that small business is the key to our growth in Memphis. It's certainly been the key to our growth in Tennessee. Although some people may say that my company is not a small business, I consider it small; certainly if you measure the profits, it's small, and even if you measure it in employees and size, we consider ourselves a small business.

Our company is in the warehousing, transportation, and distribution business. We are involved in both domestic and international transportation. We employ approximately 250 people with offices and warehouses in Memphis and several other regional States.

Overall, I feel that the impact of the tax reform and simplification proposals that the Treasury Department has proposed would generally benefit our business. Primarily, that's the result of lowering the effective tax rate, being reduced to 33 percent. Any time taxes are reduced for any business, particularly for a small business, there will be a positive impact. More dollars will be available for expansion; additional investment will be made in new equipment and innovative services, since ours is a service industry; and, obviously, new jobs will be created. And that's the name of the game for all of us.

There are, however, several aspects of the Treasury Department proposal that I feel can have adverse effect on our business and others similar to ourselves. Repealing of the investment tax credit will have a negative impact on our ability to invest in new equipment, particularly material handling and transportation equipment, since we are in the distribution industry. We have similar problems to many other companies in the mid-South and Memphis area.

The current investment tax credit provides an immediate and visible tax saving that frees dollars for continued operations. Over the last several years we've invested several hundred thousand dollars in additional and more efficient equipment and facilities to help us increase our productivity. Without these investment tax credits, I doubt seriously if we would have been encouraged to make those investments and to make the commitments and improvements that we've made.

Also, the investment tax credit available from the renovation of warehouse buildings has allowed us to restyle older structures and make them available for continued productive use. Without the tax savings many of those older buildings, frankly, would have been left to deteriorate and become unproductive eyesores in the community. I think if you look around many of the cities, particularly in the older parts of the cities, you'll see an awful lot of older buildings that for one reason or another are not renovated; many of them have been, but without the investment tax credit I know our company wouldn't have stepped forward and made the investments that we did.

No. 2, the changes in the depreciation schedule that are recommended, we feel, will only have a minimal impact on us. The changes in reality are not that great. However, from an administrative standpoint—I talked to our secretary-treasurer, and I think he voices some of the concerns of many people in small business who have the job of keeping records and changing depreciation schedules—any time you change these schedules it often requires reprograming of your asset depreciation schedule, if it's on a computer, or your manual records. As much as anything, it becomes an irritant and a time-consuming problem. Every time the IRS changes the depreciation schedules it costs us extra money to set up our books. This seems to happen each year, frankly, for the last several years.

Whatever changes are made, they should be aimed at simplifying the schedules as much as possible. Increasing the number of asset depreciation classes from three to seven is not simplification. For small businesses, simple is better.

On the positive impact side, the Treasury proposals to allow a partial dividend reduction for small business corporations is long overdue. The double taxation of dividends at both the corporate and personal level has been an irritant as well as a penalty for small businesses such as ours. Dividends are often the primary source of income to owners of small businesses. With the double tax policy, both the company and the stockholders are penalized if they use the dividends as income. We heartily encourage enactment of this particular proposal.

The proposed tax on health insurance benefits and life insurance can have a negative impact on small business. Health insurance premiums continue to rise for all of us, big or small. However, if the benefits are taxed, this will have both an impact on the take-home pay of the individual employee and subsequently increase the costs to the company. Health insurance benefits are designed to provide protection to employees and their families. For those who are fortunate not to have become sick, they never see these benefits; there is never any money in their pocket. For those who do need the protection, they never use the dollars as income. Again, this is not simplification, but complication. Simple is better.

One of the changes that's already having an impact on our business, and I gather from your comments earlier that it's already come to your attention, is that of the detailed records required in the use of company automobiles.

Senator SASSER. Has it ever come to my attention!

Mr. MALLORY. You used the term, "when the rubber meets the road" at this session; well, the rubber is meeting the road right now, I guess. [General laughter.]

Since January 1, as an example, I've tried to keep a log of every mile that I've driven in a company-owned car. Today I went to two of our offices in Memphis; I came to this hearing at Memphis State; tonight I've got a dinner with a business client, and in between I'll drive from my home to my office, which is not considered a business expense. I went to the Burger King for lunch; I'm not sure how I take that out of my schedule. And I may stop off at the hardware store to pick up something for my wife on the way home. I'm going to try and keep the record and see what happens, but I think we're almost going to need a personal computer or an accountant to ride shotgun to keep up with the detailed record requirements. If we don't, all mileage and use of the automobile is considered personal, although it's primarily a business tool. I recognize that everybody has personal use of these automobiles, but again, the complicated system is what I think will impact on small business. There needs to be a simpler way to keep track of those records.

I can foresee that many people will be encouraged to falsify their records for simplicity's sake. I don't think anybody wants to be encouraged to be dishonest or to take advantage of the system, although I think the law tends to encourage that.

Overall, Senator, I applaud the effort to simplify the tax codes and make them more equitable. However, I do not think that many of these changes are accomplishing the objective of simplicity. Since none of the tax proposals are designed to raise additional income to offset increasing deficits, I question whether we as small businessmen will not be burdened with more regulations and complications, while at the same time there is really no progress being made to reduce the deficit.

We recognize our responsibility to pay our fair share of taxes. I feel all small businessmen do. What we want is the opportunity to do that in as simple and honest an environment as possible. Additional tax revenue will come from increased business activity, increased productivity, and increased profits. They will not come from increased regulations and recordkeeping and tax computations. Simple is always better for small businessmen, whether it be in recordkeeping or in computations.

I thank you for the opportunity to speak to you, and I must confess that when I read the requirements to appear before this hearing, I was complimented to be asked. I couldn't quite meet all your requirements on copies. We ran out of copy paper at copy No. 35, so I hope that you will accept what I can leave with you.

Senator SASSER. Thank you very much.

[The prepared statement of Mr. Mallory follows:]

STATEMENT OF B. LEE MALLORY, EXECUTIVE VICE PRESIDENT, MEMPHIS COMPRESS & STORAGE CO.

I am B. Lee Mallory, executive vice president of Memphis Compress and Storage Company. Our company is in the warehousing, transportation and distribution business. We are involved in both domestic and international transportation and employ approximately 250 people with offices and warehouses in several southern States.

Overall the impact of the tax reform and simplification proposals will generally benefit our business primarily as a result of the effective tax rate being reduced to 33%. Any time taxes are reduced for any business, particularly for a small business, there will be a positive impact. More dollars will be available for expansion, additional investment will be made in new equipment and innovative services, and new jobs will be created. That's the name of the game.

However, there are several aspects of the Treasury Department's proposal that can have an adverse effect on our business.

1. Repealing the Investment Tax Credit will have a negative impact on our ability to invest in new equipment, particularly material handling and transportation equipment. The current Investment Tax Credit provides an immediate and visible tax saving that frees dollars for continued operations. Over the last several years we have invested several hundred thousand dollars in additional and more efficient equipment that helps us increase our productivity. These investments were encouraged by our use of the investment tax credits.

Also, the ITC available from the renovation of warehouse buildings allows us to restyle older structures for continued productive use. Without that tax savings many older buildings could be left to deteriorate and become unproductive eye sores in the community.

2. The changes in the depreciation schedule will have minimal impact on us. From an administrative standpoint, the change in the schedule requiring reprogramming of our asset depreciation schedule is as much an irritant as anything else. Every time the IRS changes the depreciation schedules it cost us extra money to set up our books. This seems to happen each year. Whatever changes are made, they should be aimed at simplifying the schedules as much as possible. By increasing the number of asset depreciation classes from 3 to 7 is not simplification. For small businesses simple is better.

From the positive impact side, the Treasury's proposal to allow a partial dividend deduction for small business corporations is long over due. The double taxation of dividends at both the corporate and personal level has been an irritant as well as a penalty for a small business such as ours. Dividends are often the primary source of income to owners of small businesses. With the "double tax" policy, both the company and the stockholders are penalized if they use the dividends as income. We heartily encourage the enactment of this proposal.

The proposed tax on health insurance benefits and life insurance can have a negative impact on small business. Health insurance premiums continue to rise. If the benefits are taxed, this will both have an impact on the take home pay of the individual employee and subsequently increase costs to the company. Health insurance benefits are designed to provide protection to employees and their family. For those who are fortunate not to be sick, they never use the benefits. For those who do need the protection, they never use the dollars as income. Again this is not simplification, but complication. Simple is better.

One of the changes that is already having an impact on our business is the requirement that detailed records be kept on our use of company owned automobiles. Since January 1, 1985, I have tried to keep a log of every mile I drive that relates to business. Today I went to two of our offices in Memphis, came to Memphis State University for this hearing and tonight I am scheduled to have dinner with a business client. In between I will drive from my home to my office (not considered a business expense) go to lunch and possibly stop off at the hardware store on the way to dinner. I am going to need a personal computer or an accountant to ride shotgun to keep up with the detail record requirements. If I do not, all mileage and use of the automobile is considered personal although it is primarily a business tool. I will be penalized with extra taxes and the small business will be burdened with extra record keeping.

I can foresee that many people will be encouraged to falsify records for simplicity sake. I don't think that is proper and I don't feel the tax regulations should encourage people or companies to be dishonest out of frustration. We need help on this matter.

Overall, I applaud the effort to simplify the tax codes and make them more equitable. However, I do not think that many of these changes are accomplishing the objective of simplicity. And since none of the tax proposals are designed to raise additional income to offset the increasing deficits, I question whether we as small businessmen will not be burdened with more regulations and complications and no progress in reducing the deficit.

We recognize our responsibility to pay our fair share of taxes. I feel all small businesses do. What we want is the opportunity to do that in as simple and honest an environment as possible. Additional tax revenue will come from increased business activity, improved productivity and increased profits. They will not come from increased regulations, record keeping or tax computations.

Simple is always better for small businesses.

Thank you for the opportunity to speak to you today and present my thoughts. I hope they will be beneficial.

Senator **Sasser**. Mr. Vergos, can we hear from you now?

STATEMENT OF JOHN VERGOS, RENDEZVOUS RESTAURANT

Mr. **Vergos**. Thank you, Senator Sasser. I am John Vergos, the heir apparent of the Rendezvous Restaurant. I am an attorney; I am also part owner in our family business. We have one business that is a sole proprietorship, which is running the Rendezvous Restaurant, and we have recently set up a second business called Rendezvous Commissary, Inc., which will be distributing ribs—and is distributing ribs—nationwide. I am also an attorney, but that's not my role here.

We are applauding, especially, the Bradley-Gephardt bill—which is not the one that the administration has put out—and we are very much interested in seeing something that close being passed. It's a little anecdotal; when we computed our tax returns last year, I had suggested to my dad that, at the bottom, where you insert the amount of money you owe, to write a statement and say that we will double whatever the combined taxes are paid by General Electric and Occidental Petroleum which, as you know, would amount to zero. But our tax lawyer, fortunately, was aware of the frivolous tax return law and told us that there would be criminal penalties if we did that. So we did pay our fair share of taxes.

I did not know I was going to testify until last night and I do not have my statement prepared; I'll be happy to submit it later. My remarks are not into the details of the tax return. It is maybe to state to you some anecdotes that we have had in the last 2 or 3 years in dealing with the Tax Code as it is today.

Several years ago, we were approached by a group of investors that wanted to expand our restaurant and go into business with us, to open up in another city. They were going to put most of the money up and we were going to put up some of the money, but all the knowhow and all of the labor and all of our expertise and goodwill. It's generally been our philosophy that if we were going to expand, we would want to go into a basement location because the rent is very cheap and it meets the standards that we have had. When we look for chairs we haunt the flea markets because you can buy them for 50 or 60 cents apiece. We lease our refrigeration; we lease as much equipment as we can.

As we got further down the road with our group of investors, they were putting enormous pressure on us to build a new building. They were putting enormous pressure on us when they found out we were only going to pay $2 for the chairs; they wanted $30 or $40 chairs. They also wanted to purchase our refrigeration equipment instead of leasing it, and we finally sat back and said, "Look, fellows, you're getting ready to add double the debt that we would normally have, consequently making it difficult for us to make a profit. Why is this?" And they all came up unanimously and said, "Look, we're looking at tax credits, investment tax credits, tax returns—we're looking to offset the debt that we owe the Government." And we finally said, "We're interested in making a profit; we're not really concerned about your tax consequences. As a result, you're going to make it very difficult for us to make a profit. Therefore, we will just sever our relationship and go back and run our business as we know how to do it. And if we open up another place, we'll do it on our own."

The example points out the fact that, as a result of the way the Tax Code is now, people are not investing to make a profit. In many cases, there's not an encouragement to make a profit; there's an encouragement to assume debt, to therefore write off taxes on another business. Therefore the whole basis behind the free enterprise system seems to be thwarted by regulations and the Tax Code. We have subsequently set up a separate company, as I mentioned, that will distribute ribs nationwide. We looked at it and analyzed it, and we're doing it within our business location. And there isn't a tax benefit—tax benefits did not even cross our mind before we entered into this business. We didn't even consider what the tax consequences are because we feel we can run it, we can make a profit. Consequently, with the reduction in the tax rates that appear to occur with the new law, it will encourage us to make profit and not to assume debt which could become devastating down the road.

We also own a building in a historic area where we could go in and renovate, get a facade easement, probably get involved in the Historic Tax Preservation Program, and write off a lot of debt. And we were encouraged to do that, but that's not our goal; we feel we can run our business out of our present location. And if we expand, then maybe we can go into this other business. Again, there are people encouraging you to assume more debt to the detriment of your profit.

So it's our position that is what the Tax Code has caused. We have taken a revenue-making act and we've tried to dictate social policy. If we need senior citizens' housing, we therefore provide a tax credit; or if we need more oil, we provide a tax credit. Instead of going out and saying, "We need more oil; let's do this and that," we are, in a sense, affecting a voluntary system that has worked fairly well, but the complicatedness of it, I think, is a detriment to businesses such as ours. So we are therefore very much supportive of the new proposal. We understand there must be compromises, and we are prepared to accept our own—at least, speaking for the Rendezvous—we're prepared to have some of our oxen gored. For example, I know you're going to get tremendous—from the restaurant lobby, the two-martini lunch. Well, we would just as soon see that abolished. We can live without having the deduction; people are going to still eat anyway.

So these are somewhat random comments, but I wanted to lay them out to the committee because we are in favor of it. And again, we are not a major company; we employ 50 people, and we hope that our new venture will make us even bigger.

But thank you, again, for your time.

Senator **Sasser**. Thank you, Mr. Vergos. We'll have some questions in a moment for you and Mr. Mallory.

Mr. Ratton, we'd like to hear from you now.

STATEMENT OF ROBERT W. RATTON, JR., ESQ., WILDMAN, HARROLD, ALLEN, DIXON & McDONNELL

Mr. Ratton. Senator Sasser, members of the staff of the committee and Senator Sasser's staff, I do appreciate the opportunity to appear before you today. In light of some of the comments made either directly or indirectly toward tax lawyers I take some degree of offense. However, I take only partial offense.

Senator Sasser. Now you know how politicians feel. [General laughter.]

Mr. Ratton. I guess I am doubly guilty because, fortunately, or unfortunately, I was engaged in private law practice in Washington at the time ERTA and TEFRA were passed. As such, I must share some blame, I suppose.

My oral remarks today are a supplement to the written statement filed with the committee.

First, I'd like to state that I wholeheartedly support this committee's action in attempting to determine the tax ramifications of the proposed tax reform before enacting it. In recent sessions of Congress it seems as though many times, for revenue generation or other reasons, we have simply gone to the joint committee's wish list and taken the 10 top items and enacted them without thoroughly thinking through the real impact down the road.

I would like to address one policy issue before I reach my primary topics which are the technical aspects of reform, and that is an issue which Mr. Vergos raised, and that is, will the tax system be utilized to direct the economy? I believe that if we review recent history the answer to that question has been a positive yes. The whole reason for the passage of the Economic Recovery Tax Act of 1981 was to stimulate the economy, to stimulate the investment in new equipment. Everyone at that point at least had surface knowledge of the fact that the present value of the ACRS provisions, when coupled with investment tax credit, was greater than current expensing at discount rates of 17 percent or less. Even after TEFRA, the present value of the cost recovery allowances and ITC are greater than current expensing at discount rates of 10 percent or less.

Less than a year after ERTA, TEFRA made some inroads on the incentives created by ERTA. An economic reappraisal process had commenced, I suppose. Then we had DEFRA, the 1984 Tax Act. And the 1984 act raises the code to new heights in complexity and made all we tax persons purchase Hewlett-Packard calculators so that we could learn present value concepts. And at this point, a businessman can't enter into a lease for more than a year without running his lease payments through his financial calculator and tax adviser.

The present system is too complex, and I would be the first one to admit that. It is absolutely ridiculous in its complexity. The cost of tax advice to small businesses has gotten out of hand. By way of example, I get many phone calls each week over what should be simple yes-or-no questions; but by the time I tell the client that I have to go run that problem through ERTA, TEFRA and DEFRA to determine an answer, the cost of tax advice may be greater than the cost of the problem.

Focusing more specifically on the provisions of the Internal Revenue code affected by the Treasury's tax reform proposal and some of the other tax reform proposals, I think initially you do have to step back and look at why the code has become complex, at the background of the provisions that are in the code which are now discussed for amendment. Most provisions in the code, at least at some point in time, had some reason for their existence. I'm not saying that that reason hasn't long gone by and the provisions are not stale and should be cast away.

Looking first at the investment tax credit or ITC, that's certainly not a new animal at all; it came into existence originally in 1962. It was on-again and off-again many times and finally, in the 1970's, was made "permanent." The ITC is a credit against tax for investment in certain property. The ITC has really no counterpart in financial accounting; it's a pure incentive. Objectively, the ITC rates should be adjusted from time to time to reflect the stimulation needed in the economy, assuming you use the Tax Code for such incentives.

I would agree with Mr. Mallory that the elimination of the ITC would certainly depress the incentive to acquire equipment.

Now, moving on to the accelerated cost recovery system, the ACRS provisions, I think it's common knowledge that all tax systems recognize some method of cost recovery. Cost recovery differs conceptually from ITC, the investment tax credit. Cost recovery is not, in and of itself, an incentive; cost recovery is merely a method of recovering your cost in the purchase of an asset. When the term or the period of that recovery becomes less than the useful life of the asset, you then create the potential of incentive within an otherwise-neutral provision.

It would also be useful to note that there were actually two reasons for the ACRS provisions. One was to provide an additional incentive for the purchase of equipment; the other was to eliminate the incredible waste of time in IRS audits. When the Internal Revenue Service audited taxpayers for the years prior to 1981, incredible energy, time, legal expense was incurred to merely establish the useful life and proper depreciation method for an asset. We can certainly argue over what the appropriate term, 10–5–3 or 15–5–3 or 18–5–3 or longer, is appropriate. But the concept of simple, limited number of recovery periods I think is extremely sound in a tax administration sense.

The Treasury proposal, of course, does replace the ACRS provisions with the real cost recovery System, RCRS; and the RCRS periods more closely are based on economic life and hence would be more neutral or less of an incentive. Further, the RCRS provisions add a provision for indexing the basis of property. If you read through the Treasury report on its proposal, the interesting comment you have to make is that you don't know whether you're better off under ACRS or RCRS until you know the future inflation rate. If the inflation rate is over 5 percent, then in the shorter term classes of property you are better off under the Treasury proposal. As the inflation rate reaches 10 percent, then you are better off in all classes of property on a present value basis under the

Treasury proposal. Thus, the assumed inflation rate becomes very critical.

With respect to current expensing, current expensing has been considered as an option to replace the entire cost recovery system. When hearings on the 1981 Tax Act, ERTA, were held, many people proposed at that time that we go to a current expensing technique. Some people even complicated that by saying that we should take a current deduction for the present value of a hypothetical depreciation stream. What we have today is very limited expensing; it's limited to $5,000 of equipment in a year. The amount was scheduled to rise, but because of budgetary constraints, it was held at the $5,000 annual level. This, then, makes it a provision which is, actually, solely of importance to small business. In large businesses it really becomes insignificant. It is a small business benefit.

With respect to the capital gains provision, the preferential treatment of long-term capital gains was commenced in 1921 and since that time we have had, in one form or another, preferential treatment for long-term capital gains. There are several arguments in favor of the provision. One is to avoid taxing income earned over a period of years in a single year, or the "bunching" effect; a second is to avoid the disincentive for the disposition of property—in other words, to promote the free transferability of property; and a third reason often given is to avoid taxation due solely to inflationary pressure.

Current law is very favorable; it was changed in 1978 to provide individuals a 60 percent deduction from their income for long-term capital gains, therefore taxing 40 percent of such capital gains. And working that through the computer, it results in a 20-percent maximum rate on capital gains for individuals. Corporations pay a 28-percent maximum rate on capital gains. The important point here again is not what I've just said; the important point, at this juncture in our study, is to realize that the capital gains provisions don't only apply to securities and to real estate. The effect of preferential treatment is very industry specific. The timber industry, the coal industry, the domestic iron ore industry, and taxpayers involved in the transfer of patents all receive special capital gains treatment. Certain of these provisions were drafted into the code during World War II and the post-World War II period to place timber and coal on a parity with other energy resources. And I think we must examine the effect of removing the capital gains provisions on these disparate industries before we simply say that it is good to tax all income at one rate. In other words, there may be some adjustments necessary other than merely the removal of capital gains.

Senator SASSER. We had some discussion this morning that the Treasury Department tax proposal does not take into consideration the difficulties or peculiarities of specific industries. There was some disparity of opinion as to whether or not that really ought to be done. Some of our small business witnesses were saying it's not Government's business to make a determination about whether or not an industry is being hurt or helped by a tax system. Others took a contrary position. Do you have any views on that, Mr. Ratton?

Mr. **Ratton**. At this point in time I have views, but I have no answer.

Senator **Sasser**. I see.

Mr. **Ratton**. At this point in time I think that the jury is out, what we have to do is examine the effect on these industries and realize that all businesses are not the same. It's fine to say we're going to place everyone on a level playing field, but let's run enough economic models to be certain that that's what we're doing by passing a simplified structure.

I would make the same comments that earlier witnesses have on the single tax rate as applied to small businesses. The Treasury proposal actually is a tax increase for small businesses up to approximately the $160,000 taxable income level.

And in closing, if I might just speak to complexity for just about 1 minute. We have had tax legislation, major tax legislation, in each of the past 4 years, and we've had major changes and increased complexity. Pursuant to section 280F of the 1984 act, it takes three and one-half pages of the Internal Revenue Code to explain the depreciation of a company car. We have had over 1,500 pages of tax legislation in the last 4 years. The target is now so rapidly moving that taxpayers feel if they don't jump quickly, their favorite benefit will escape. There are 453 active regulations projects currently in the Internal Revenue Service. That's 453 sets of tax regulations that are in the mill, to come out at some point. Meanwhile, the provisions of the Tax Code get more ambiguous and obscure.

In closing, if I could just read two of my favorite provisions that came in under DEFRA. Believe it or not, this is in the "definitions" section of the Internal Revenue Code, buried over on page 5,975-8, section 7701(e), and it's captioned: "Treatment of Certain Contracts for Providing Services, etc." The et cetera is not mine; it's in the Code. "For purposes of chapter 1, a contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors, including the following," and it lists about seven or eight factors. And at that point I was breathing heavily because I didn't understand what it said to that point. And then I got to subsection (2), and (2) says "Other Arrangements." "An arrangement, including a partnership or other passthrough entity, which is not described in paragraph 1 shall be treated as a lease if such arrangement is properly treated as a lease taking into account all relevant factors, including factors similar to those set forth in paragraph 1.

Now, really, my other favorite is just a continuation of that same section. This is, again, a definitional section—this is 7701(f)—"Use of Related Persons or Passthrough Entities." [General laughter.]

"The Secretary shall prescribe such regulations"—I suppose this is one of the 453 projects we currently have in the works—"The Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title"—title is the whole code, it's all those 6,000 pages before this—"which may deal with, one, the linking of borrowing to investment, or, two, diminishing risks through the use of related persons, passthrough entities, or other intermediaries."

I would submit to you that I certainly don't understand either one of those provisions merely from reading them. I do know why they were placed in the code and, for that reason, what they are meant to accomplish. Those provisions may be some of the strongest arguments, along with the other 800 or 900 pages of DEFRA, the 1984 act, in favor of the Treasury proposal.

I thank you for letting me have this time.

Senator **Sasser**. Well, thank you very much.

[The prepared statement of Mr. Ratton follows:]

STATEMENT OF
ROBERT W. RATTON, JR. ESQ.
WILDMAN, HARROLD, ALLEN, DIXON & MCDONNELL
BEFORE THE
COMMITTEE ON SMALL BUSINESS
JANUARY 9, 1985

INTRODUCTION

I am Robert W. Ratton, Jr., a partner in the law firm of Wildman, Harrold, Allen, Dixon & McDonnell, Memphis, Tennessee. My practice is restricted to Federal Income Taxation. In such practice and previously during my practice with a Washington, D.C. law firm, I have advised taxpayers (corporate, partnership, and sole proprietorship) in tax planning for various transactions and in operating their businesses. The vast majority of my practice concerns the representation of business clients. Our law firm represents a broad base of business clients in diverse fields of endeavor. With a few exceptions the businesses are closely held enterprises.

I support and applaud the efforts of this Committee in examining the effects of the proposed legislation. In recent legislative sessions too little consideration has been given to the effects of tax legislation upon the various sectors of the economy.

I am here today to comment upon various aspects of pending proposals to reform our federal income tax system. In so commenting I will speak primarily from a technical viewpoint as the policy comments are to be made by others. However, I would be remiss in my comments if I did not address what I feel to be a critical and necessary policy analysis which must be undertaken before any restructuring of our tax system is undertaken.

Much has been made of creating a "level playing field" for all taxpayers. Further, the reform packages which are on the legislative table speak to removing many of the incentives which have become a part of the Internal Revenue Code ("Code") to create this "level field". The basic policy question is simple to state - Will the tax system be utilized to direct the economy? The answer to the question, at least until 1982, was certainly "yes".

During the hearings preceding the Economic Recovery Tax Act of 1981 ("ERTA"), the focus was squarely aimed at providing economic incentives through the Code. The industries assisted by ERTA would perhaps strongly argue that they were placed on a "level playing field" by ERTA. As an example, ample discussion of the effects of the Accelerated Cost Recovery System ("ACRS") when coupled with the Investment Tax Credit ("ITC") was had prior to the enactment of ERTA. It is a fact that, if a discount rate of less than 17% is utilized, the present value of ACRS plus ITC, as both were constituted in ERTA, is greater than granting a current deduction for equipment purchased. However, at the point in time of the passage of ERTA the incentives provided were considered necessary. Perhaps the passage of time necessitates the reappraisal of the prior necessities.

The Tax Equity and Fiscal Responsibility Tax Act of 1982 ("TEFRA") was a formal step in the reappraisal process. The economic forces were reexamined. In fact in setting out the rationale for the revenue proposals in the bill that became TEFRA the Senate Finance Committee discussed perceived abuses stimulated by ERTA and incentives which were perceived as too rich. TEFRA scaled back many of the ERTA incentives less than a year after such incentives were added to the Code.

What TEFRA started the Deficit Reduction Tax of 1984 ("DEFRA") surely carried on with a new vigor and a higher level of complexity. Present value concepts were liberally spread through the Code. After DEFRA all tax practitioners must possess a calculator capable of performing intricate present value computations. DEFRA also has one of the most blatant attempts to direct business conduct through a Code provision. The so called Golden Parachute provision. This provision inhibits corporations from giving extended deferred compensation to existing management in the event of a takeover of the business.

SPECIFIC PROVISIONS INCLUDED IN TAX REFORM PROPOSALS

OVERVIEW

From a technical viewpoint it is important to understand the rationale behind the tax provisions which we are requested to discuss today. Most if not all the complex provisions of the Code were placed in the Code for a particular purpose. This is not to say that the purpose may be invalid at the current time; however, the time has come to cease "knee jerk" tax reform. The time has come for a study of our tax system which is deliberate and thoughtful.

INVESTMENT TAX CREDIT

The ITC was added to the Code in 1962. It was at first a temporary provision and was intended to stimulate investment in equipment. After a checkered history of "on again - off again" times, the ITC was made a "permanent" part of the Code in the 1970's. The ITC has no counterpart in financial accounting. The intent and purpose of the ITC is to act as a stimulant or incentive to investment. From an objective standpoint the ITC should be adjusted from time to time to reflect the degree of stimulation needed. This of course presumes that the Code will be utilized for directing the economy.

The ITC, subject to various limitations, currently provides a credit against income tax equal to 10% of the cost of most equipment and 6% for cars and light trucks. TEFRA provides that the basis of property, for ACRS purposes, is reduced by one-half of the ITC taken on such property. Viewed in isolation, the removal of the ITC provisions would certainly act as a depressant on the purchase of equipment.

ACCELERATED COST RECOVERY SYSTEM ("ACRS")

All tax systems recognize the need for a method by which a business may recover the cost of acquiring depreciable property. Cost recovery differs conceptually from ITC in that depreciation or cost recovery is not necessarily an incentive.

The ACRS provisions were added by ERTA as the result of some intensive efforts by certain segments of industry to simplify the then utilized depreciation system. Looking back, the system utilized pre-ERTA was often uncertain and resulted in an incredible amount of effort being expended by taxpayers and the Internal Revenue Service ("IRS") in establishing the proper depreciation period for a particular asset.

Some simplification was brought about prior to ERTA by regulations promulgated in the early 1970's by the IRS. These Asset Depreciation Range ("ADR") regulations provided certain safe harbor useful lives for assets but also demanded the taxpayers comply with many complex rules.

The ACRS provisions of ERTA replaced the very complex system with four basic classes of property known as 3 year, 5 year, 10 year and 15 year property. The cost of ACRS property is recovered over the assigned period on an accelerated basis. The recovery periods are generally shorter than the useful life of the affected asset. Both TEFRA and DEFRA made changes to ACRS so that we now have 3 year, 5 year, 10 year and 18 year property, except for certain low income housing which remains 15 year property. Very few assets fall within the ten year class. Cars and light trucks are three year property. The vast bulk of remaining equipment is five year property. Commercial and most residential real estate improvements are generally eighteen year property.

The Treasury proposal replaces the ACRS provisions with the Real Cost Recovery System ("RCRS"). The recovery periods over which the RCRS allow a business to recoup its capital investment are longer than the ACRS provisions, more closely based upon the economic life of an asset, and more categories are provided than in the ACRS system. The RCRS provisions do provide for an indexing of tax basis for inflation. Whether the present value of RCRS allowances or ACRS allowances is greater depends upon the assumed inflation rate. The inflation rate required to equate the two systems varies for different classes of property but appears to be between 5% and 10%, depending upon the particular class of property.

CURRENT EXPENSING

Current expensing of equipment was considered as one possible alternative method of cost recovery during the debate over ERTA. As a potential modification to expensing, some individuals proposed a current deduction in the year of purchase for the present value of a hypothetical depreciation stream from the asset. ERTA did provide a limited form of current expensing in an amount not to exceed $5,000 in one year if a taxpayer so elects. The ITC is not available for an amount which has been expensed by the taxpayer. This amount was scheduled to increase but due to subsequent legislation, the amount remains at $5,000 for 1985. The currently scheduled increases are not likely to take place in the current economic and political climate.

The current expensing provision is of significance only to small business due to the $5,000 per year limitation, thus a curtailment of the expensing provision would directly effect small business. The Treasury proposal retains the limited provision for expensing initiated in ERTA, although the other proposals generally do not retain the expensing election.

CAPITAL GAINS

The preferential treatment of long term capital gains commenced in the year 1921 and has been in the Code since that time. Several arguments have been propounded in favor of the preferential tax treatment. The major arguments are: avoid taxing of income earned over a period of years in a single year; avoid the disincentive of disposing of property; avoid the taxation of the increases in value due to inflation.

Under current law, individuals receive a deduction equal to 60% of net long term capital gains and the remaining 40% of the such gains are taxed at the taxpayer's ordinary income tax rate.

Effectively, the maximum tax rate which an individual may pay on net long term capital gains is 20%. Corporations pay a maximum capital gains tax of 28%.

The effect of provisions providing for favorable tax treatment for long term capital gains are very industry specific. Certain industries are very reliant on such preferential treatment, for example - timber, coal, and domestic iron ore industries. One must examine the reason for such incentives were placed in the Code prior to the elimination of the favorable tax treatment. Such an examination is far beyond the scope of this statement. One important factor to consider is that the provisions affect more than the purchase and sale of securities and real estate.

Under the Treasury proposal, the nominal rates of tax imposed upon net long term capital gains would increase and such gains would be taxed at the same rate as ordinary income. The benefit provided by the Treasury proposal is the indexing of tax basis by an inflator based upon the Consumer Price Index.

The Treasury proposal may well reduce the tax burden on some property held for long periods of time but will increase the burden on property held for relatively short periods of time. The Treasury admits that investors in ventures which are highly successful over short periods of time will be harmed by its proposal. This increased burden may inhibit the pool of venture capital.

NOMINAL AND EFFECTIVE TAX RATES

The reduction in the maximum nominal tax rate also demands special scrutiny when the concern is limited to small business. It has become customary to say that the tax rate for corporations is 46%. This is not accurate. The current law has a progressive rate structure for corporations. After DEFRA corporations with taxable incomes in excess of $1,000,000 lose the benefit of the progressive rates. The current progressive rate structure is as follows:

Taxable Income	Marginal Tax Rate
0 to 25,000	15%
25,001 to 50,000	18%
50,001 to 75,000	30%
75,001 to 100,000	40%
100,001 and over	46%

The Treasury proposal has a flat rate of 33% for corporate income. However, under current law the corporate taxable income must reach approximately $160,000 before the income tax as a percent of the taxable income (the effective average tax rate) reaches 33%. Thus certain small businesses could suffer if the other benefits of the Treasury plan, the limited deductibility of dividends for example, are not realized by such an enterprise.

The problem cannot be stated as simply as indicated above. Many models must be run to determine the true impact of the reform proposals upon the small business.

RECENT INSTABILITY AND COMPLEXITY IN THE TAX SYSTEM

In the eyes of the tax advisor a major concern is the instability of the tax system and the incredible uncertainty of the future. These factors have taxpayers scrambling to take advantage of provisions which may appear short-lived. Further, long range planning in such an environment is virtually impossible.

Each year of the past four years has seen major tax legislation. The recent tax legislation has raised the complexity of the Code to levels unthinkable only a few years ago. For example, Section 280F of the Code, added by DEFRA, devotes three and one-half pages to the depreciation of and ITC with respect to "Luxury Automobiles" and certain "personal use property".

Section 7701(e) and (f) also added by DEFRA are two of my personal favorites and a copy of these provisions is attached to this statement. Their ambiguity is astounding. The significance of such provisions can only emerge as taxpayers and practitioners see how such provisions are applied by the IRS and the courts.

A further indication of the overdrive rate of tax legislation may be found in the Report by Legislation and Regulations Division of Office of Chief Counsel of the Internal Revenue Service on the Status of Regulations Projects as of November 30, 1984. The Office of Chief Counsel reports 453 active regulation projects. This means that 453 separate sets of regulations are in the process of being drafted. The potential regulations now caught in these projects are needed by taxpayers for guidance in legitimate business transactions.

The backlog continues to grow as new provisions are added to the Code. Additionally, the recent Code amendments are much more "regulation intensive" than prior legislation. Recently enacted legislation often substitutes the grant of regulatory authority in place of drafting complete legislation.

If the tax legislation passed in only the past four years were assembled it would be an impressive stack of paper comprising some 1,500 pages. As a tax professional I must make some attempt not only to read this mass of print but also understand it. Should or can we expect small business to pay the high cost of tax advice on the constantly changing provisions.

So long as people perceive the tax system as a rapidly moving target they are compelled to jump at tax schemes without proper advice and no amount of new tax penalties and enforcement personnel will be able to stop this. Strangely enough much of the recent legislation has been directed toward closing loopholes and making the present tax system more fair. In reality the recent legislation has so increased the complexity of the law that distrust of the system has increased.

CONCLUSION

What is needed is an orderly study of the tax system. A full report of the alternatives and a critical appraisal of such alternatives and their effect on U.S. business. In the meantime slow down the process. Give taxpayers, the IRS and, not the last, tax advisers the time to understand what we have currently in the Code.

Proposals such as those offered by the Treasury and members of the Senate and the House may eventually provide the desired and needed relief. But the proposals must receive thorough scrutiny during the deliberative process.

Hearings such as these are essential to the process of determining the issues presented by tax reform on the magnitude under consideration. I very much appreciate the opportunity to share my views on this subject.

[Sec. 7701(d)]

(d) COMMONWEALTH OF PUERTO RICO.—Where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, references in this title to possessions of the United States shall be treated as also referring to the Commonwealth of Puerto Rico.

Source: New.

Amendments:	Sec. as amended effective:
P.L. 98-369, § 138(a)	....

The above amendment applies to tax years beginning after December 31, 1984.

P.L. 98-369, § 138(a):
Act Sec. 138(a) amended Code Sec. 7701 by redesignating subsection (c) as subsection (d).

[Sec. 7701(e)]

(e) TREATMENT OF CERTAIN CONTRACTS FOR PROVIDING SERVICES, ETC.—For purposes of chapter 1—

(1) IN GENERAL.—A contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors including whether or not—

(A) the service recipient is in physical possession of the property,

(B) the service recipient controls the property,

(C) the service recipient has a significant economic or possessory interest in the property,

(D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

(E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and

(F) the total contract price does not substantially exceed the rental value of the property for the contract period.

(2) OTHER ARRANGEMENTS.—An arrangement (including a partnership or other pass-thru entity) which is not described in paragraph (1) shall be treated as a lease if such arrangement is properly treated as a lease, taking into account all relevant factors including factors similar to those set forth in paragraph (1).

(3) SPECIAL RULES FOR CONTRACTS OR ARRANGEMENTS INVOLVING SOLID WASTE DISPOSAL, ENERGY, AND CLEAN WATER FACILITIES.—

(A) IN GENERAL.—Notwithstanding paragraphs (1) and (2), and except as provided in paragraph (4), any contract or arrangement between a service provider and a service recipient—

(i) with respect to—

(I) the operation of a qualified solid waste disposal facility,

(II) the sale to the service recipient of electrical or thermal energy produced at a cogeneration or alternative energy facility, or

(III) the operation of a water treatment works facility, and

(ii) which purports to be a service contract,

shall be treated as a service contract.

(B) QUALIFIED SOLID WASTE DISPOSAL FACILITY.—For purposes of subparagraph (A), the term "qualified solid waste disposal facility" means any facility if such facility provides solid waste disposal services for residents of part or all of 1 or more governmental units and substantially all of the solid waste processed at such facility is collected from the general public.

(C) COGENERATION FACILITY.—For purposes of subparagraph (A), the term "cogeneration facility" means a facility which uses the same energy source for the sequential generation of electrical or mechanical power in combination with steam, heat, or other forms of useful energy.

(D) ALTERNATIVE ENERGY FACILITY.—For purposes of subparagraph (A), the term "alternative energy facility" means a facility for producing electrical or thermal energy if the primary energy source for the facility is not oil, natural gas, coal, or nuclear power.

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(E) WATER TREATMENT WORKS FACILITY.—For purposes of subparagraph (A), the term "water treatment works facility" means any treatment works within the meaning of section 212(2) of the Federal Water Pollution Control Act.

(4) PARAGRAPH (3) NOT TO APPLY IN CERTAIN CASES.-

(A) IN GENERAL.—Paragraph (3) shall not apply to any qualified solid waste disposal facility, cogeneration facility, alternative energy facility, or water treatment works facility used under a contract or arrangement if—

(i) the service recipient (or a related entity) operates such facility,

(ii) the service recipient (or a related entity) bears any significant financial burden if there is nonperformance under the contract or arrangement (other than for reasons beyond the control of the service provider),

(iii) the service recipient (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract or arrangement, or

(iv) the service recipient (or a related entity) has an option to purchase, or may be required to purchase, all or a part of such facility at a fixed and determinable price (other than for fair market value).

(B) SPECIAL RULES FOR APPLICATION OF SUBPARAGRAPH (A) WITH RESPECT TO CERTAIN RIGHTS AND ALLOCATIONS UNDER THE CONTRACT.—For purposes of subparagraph (A), there shall not be taken into account—

(i) any right of a service recipient to inspect any facility, to exercise any sovereign power the service recipient may possess, or to act in the event of a breach of contract by the service provider, or

(ii) any allocation of any financial burden or benefits in the event of any change in any law.

(C) SPECIAL RULES FOR APPLICATION OF SUBPARAGRAPH (A) IN THE CASE OF CERTAIN EVENTS.-

(i) TEMPORARY SHUT-DOWNS, ETC.—For purposes of clause (ii) of subparagraph (A), there shall not be taken into account any temporary shut-down of the facility for repairs, maintenance, or capital improvements, or any financial burden caused by the bankruptcy or similar financial difficulty of the service provider.

(ii) REDUCED COSTS.—For purposes of clause (iii) of subparagraph (A), there shall not be taken into account any significant financial benefit merely because payments by the service recipient under the contract or arrangement are decreased by reason of increased production or efficiency or the recovery of energy or other products.

(5) EXCEPTION FOR CERTAIN LOW-INCOME HOUSING.—This subsection shall not apply to any low-income housing (within the meaning of section 168(C)(2)(F)) if—

(A) such property is operated by or for an organization described in paragraph (3) or (4) of section 501(c), and

(B) at least 80 percent of the units in such property are leased to low-income tenants (within the meaning of section 167(k)(3)(B)).

(6) REGULATIONS.—The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the provisions of this subsection.

Source: New.

Amendments:	**Sec. as amended effective:**
P.L. 98-369, § 31(e)	....

P.L. 98-369, § 31(e):

Act Sec. 31(c) amended Code Sec. 7701, as amended by this Act, by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) new subsection (e), above.

The above amendment applies to property placed in service by the taxpayer after May 23, 1983, in taxable years ending after such date, and to property placed in service by the taxpayer on or before May 23, 1983, if the lease to the tax-exempt entity is entered into after May 23, 1983. Special rules appear in Act Sec. 31(g) following Code Sec. 168.

[Sec. 7701(f)]

(f) USE OF RELATED PERSONS OR PASS-THRU ENTITIES.—The Secretary shall prescribe such regulations as may be necessary or appropriate to prevent the avoidance of those provisions of this title which deal with—

(1) the linking of borrowing to investment, or

(2) diminishing risks,

through the use of related persons, pass-thru entities, or other intermediaries.

Source: New.

Amendments:	Sec. as amended effective:
P.L.98-369, § 53(c)	7-18-84

P.L.98-369, § 53(c):

Act Sec. 53(c) amended Code Sec. 7701 by redesignating subsection (f) as (g) and by inserting after subsection (e) new subsection (f), above.

[Sec. 7701(g)]

(g) CLARIFICATION OF FAIR MARKET VALUE IN THE CASE OF NONRECOURSE INDEBTEDNESS.—For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

Source: New.

Amendments:	Sec. as amended effective:
P.L.98-369, § 75(c)	

P.L.98-369, § 75(c):

Act Sec. 75(c) amended Code Sec. 7701, as amended by this Act, by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) new subsection (g), above.

The above amendment applies to distributions, sales, and exchanges made after March 31, 1984, in tax years ending after such date.

[Sec. 7701(h)]

(h) CROSS REFERENCES.—

(1) OTHER DEFINITIONS.—

For other definitions, see the following sections of Title 1 of the United States Code:

(1) Singular as including plural, section 1.

(2) Plural as including singular, section 1.

(3) Masculine as including feminine, section 1.

(4) Officer, section 1.

(5) Oath as including affirmation, section 1.

(6) County as including parish, section 2.

(7) Vessel as including all means of water transportation, section 3.

(8) Vehicle as including all means of land transportation, section 4.

(9) Company or association as including successors and assigns, section 5.

(2) EFFECT OF CROSS REFERENCES.—

For effect of cross references in this title, see section 7806 (a).

Source: New.

Amendments:	Sec. as amended effective:
P.L. 98-369, § 31(e)	
P.L. 98-369, § 53(c)	7-18-84
P.L. 98-369, § 75(c)	
P.L. 98-369, § 138(a)	

P.L. 98-369, § 31(e):

Act Sec. 31(e) amended Code Sec. 7701, as amended by this Act, by redesignating subsection (e) as subsection (f).

See the notes following Code Sec. 7701(e) for the effective date.

P.L. 98-369, § 53(c):

Act Sec. 53(c) amended Code Sec. 7701 by redesignating subsection (f) as (g).

P.L. 98-369, § 75(c):

Act Sec. 75(c) amended Code Sec. 7701, as amended by this Act, by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) new subsection (g), above.

Senator **Sasser**. Let me ask you a question. Bob, do most of your small business clients file as corporations or do they file individual tax returns?

Mr. **Ratton**. We have a fairly good mix. I'd say the majority are corporate taxpayers; a fair number of those corporate taxpayers are "sub-S" or now "S" corporations which are basically taxed as partnerships.

Senator **Sasser**. Well, of your small business clients which use the corporate tax return form, how many use the progressive corporate tax return structure? How important are these progressive rates, in your judgment, to your small business clients who file corporate tax returns?

Mr. **Ratton**. We have a fair number of clients who significantly benefit from the progressive rate. Basically, if you run the numbers, it's a $20,250 break. If you work the numbers out through the 46-percent maximum rate, the graduated rates currently give you about a $20,250 break and a fair number of the clients consider this benefit important. You will note in the 1984 act, however, that the benefits of the graduated rates are phased out for corporations with taxable incomes in excess of $1 million. But the answer to your question is, a good number do take advantage of the graduated rates.

Senator **Sasser**. A year or two ago, we got something in the Tax Code for small business, a concept called direct expensing. Are all of you familiar with that concept, where you can immediately write off something that you buy, up to $5,000? Originally, this ceiling was to increase to $10,000, but there has been some scaling back lately. Based on our testimony today, I am afraid we may be losing a valuable small business tool.

One of the perceived abuses of many tax preferences, the polite word given to deductions and credits, is that they promote investments based on tax consequences, rather than investments based on sound economic decisions which produce some sort of real, tangible gain for the economy as a whole.

Do you find this problem exists with the investment tax credit concept? I ask this question of anyone on the panel who wishes to comment. In other words, do you think that investment tax credits are effective in directing people to sound economic decisions, as opposed to investing simply for a favorable tax consequence?

Mr. **Mallory**. If I might, Senator, I think they do in our case as a small business looking to improve its facilities and add to its equipment. We buy an awful lot of equipment each year. You can buy one and a half Cadillacs for one lift truck in your warehouse, and you need lots of lift trucks to handle the needs. On the other hand, John Vergos talks about the investment tax credit as a tax avoidance gimmick in his situation. Well, I think they're two different situations. As a small business, we take advantage of that and that helps us to make new investments. It provides a cash-flow advantage that was commented on by the earlier testifiers. In John's case that was not a business decision, that was an investment decision. That was a tax avoidance situation.

So in answer to your question, it helps us and it helps many businesses in our industry, I think, to free up cash that would otherwise go for taxes. They can then use that money to invest in more productive equipment.

Mr. **Vergos.** I was just going to respond that, should the rates be lowered to a more reasonable level, would that not offset the gain that you would have by the investment tax credit? You'd be paying less taxes if the rates were reduced. It's part and parcel—I don't know. I'm just throwing that out.

Mr. **Mallory.** I think you need to take a look at that. I mean, I'm sure they need to run some models on it. I don't know; I'm just speculating. If you go to invest—buy—a $30,000 lift truck, as an example, you can see an immediate $3,000 tax credit coming back; that is immediate savings. And I think many small businesses look at it that way. In the case of buildings, we saw some significant savings in our tax bill when we renovated some older buildings that we probably would not have renovated had that not been available.

Senator **Sasser.** Well, what—excuse me, go ahead.

Mr. **Vergos.** Just one other point about that. We were approached—this building had been renovated in downtown Memphis; costs were extremely high, and they tried to sell it by showing what our cash flow would be because we would therefore reap all this benefit from the tax consequences. We explained to them, well, what if we don't have an income this year? We want to invest in something where the building will fly on its own; and if you can offer tax credits, that's just an extra incentive. But a lot of people develop a building and use the tax savings as an inducement and to show that your cash flow will offset the mortgage. So I think a lot of people are taken in to buy something like that. You may not have any income the next year and, consequently, you're stuck with a bad investment.

Senator **Sasser.** What's your view on that, Bob?

Mr. **Ratton.** There is no doubt that equipment is purchased due, in small or large part, to the investment tax credit plus the ACRS provisions. We have clients who would not have aircraft today, who would not have equipment today if it weren't for those provisions. However, speaking to what Mr. Vergos is talking to, the tax shelter concept, it is true that many vehicles are sold primarily based on tax incentives. Specifically, I think he mentioned rehabilitation credit, when you do couple the facade easement with the 25-percent historic structure rehabilitation credit plus even the straight-line recovery you have to take on top of that, it offers a tremendous tax incentive. But to be honest, I don't know that I've seen in any transactions which are not of economic substance work because of tax benefits. They may be sold to work, but they become not tax losses but real losses some years down the road.

The problem, I suppose, that we have now is, as the Treasury proposal points out, a tremendous front loading of the system. When you take the investment tax credit coupled with big front-end depreciation deductions, you do get into a posture where you get these enormous 4-, 5-, 6-to-1 writeoffs in the initial year. And to that extent, certainly, the Tax Code does influence and direct investment toward those activities. But I think that most of them that are done solely for tax avoidance fail and become real losses 4 or 5 years down the road.

Senator **Sasser**. Well, gentlemen, thank you very much for appearing here today and giving us the benefit of your views. It's been very helpful and I'll say to you what we said to the other panel. If you have some stroke of inspiration within the next 3 weeks and want to submit something to be added to the complete record, please feel free to do so.

Mr. **Mallory**. When would the Congress act on this, in your opinion?

Senator **Sasser**. Well, I think there's a real open question whether or not the Congress will act on it at all. I think very much will depend on the administration's attitude. Initially the new chairman of the Senate Finance Committee, Senator Packwood, made a comment that he liked the Tax Code the way it was, indicating that there was not going to be any movement in the Senate Finance Committee as far as he was concerned. Now, since that time the President has given the plan sort of a lukewarm endorsement. But I understand that there is some momentum building in the administration to really move forward and push this so-called tax reform proposal. If that is the case, the Congress could be dealing with it toward the latter part of this year. If that's not the case, I expect that it will probably fall off the radar scope for this year and might reemerge next year. I say it's the Treasury Department's plan, it's their program, and it's going to depend on how vigorously the administration presses it and pursues it. If they really press it, then I think there will be hearings in the Finance Committee and it may emerge and be on the floor by sometime this fall. If they don't, then we won't see it treated seriously until next year, if at all.

Gentlemen, thank you very much.

Our next panel is a distinguished panel. Ms. Katherine Smythe, the owner of the Memphis Memorial Park and Cemetery, a successful businesswoman here in Memphis, if you would come forward, please; DeWayne Bolton, the owner of ECOM Systems, a business which sells computer systems to financial institutions; and Mr. John Toma, who is here in Mr. Aldrich's place, as he was detained. We welcome you, Mr. Toma, and thank you for appearing here today.

Why don't we begin with you this afternoon, Ms. Smythe. Thank you for appearing.

STATEMENT OF KATHERINE HINDS SMYTHE, PRESIDENT, MEMPHIS MEMORIAL PARK, INC.

Ms. **Smythe**. Thank you. First, my business is truly a small business; we have about 81 full-time employees and numerous others part time, because of the nature of our business, and we are a regulated business, very heavily regulated by the State of Tennessee.

In general, and my remarks are very brief and very general, I urge the committee to work toward these goals: stability of tax rules so that businesses and individuals may plan for the future—we may even need a moratorium on tax changes so that we can pause and plan—and the second point in general, stimulation of small business and the private sector.

With reference to the first point, I think we should leave certain basics absolutely alone; investment tax credits and depreciation are good.

Concerning the second point, the Federal Government seems currently intent on turning more responsibility over to local and State governments, and to the private sector. For this to happen there must be stable small businesses with appropriate regulation; and I think some of the regulations that govern me and my husband's business are appropriate, but without the burden of unnecessary rules, restrictions, and paperwork.

Some of the proposed tax changes may create a greater burden for the small businesses and cause more tax avoidance than compliance. An example of this would be the automobile rule; I think that enough has been said about that. I think an automobile is as basic as a telephone to many businesses, and certainly it's going to be very difficult for me to keep proper records.

Some of the Treasury plan proposals concerning mortgage interest and property taxes seem aimed at abusive tax shelters. I have talked to some experts who believe that there are adequate laws on the books right now to control this, and we don't need additional rulings. If you change the rules on mortgage interest and property taxes you could truly hurt real estate investment and you might even help destroy the banking industry, which is already having trouble.

Senator **Sasser**. You'll be interested in knowing that the National Association of Realtors have been very critical in their comments about this legislation, proposed legislation.

Ms. **Smythe**. I'm sure they have.

Buying real estate personally is one way the small business owner can build for his family's future. I think we should be allowed to deduct interest and taxes on that. Since banks rely on the interest income, the Treasury plan would help hasten their ruin, and they're already having problems.

The proposed restrictions on health insurance, business-related entertainment and business travel are just nit-picking, I think. That's the kind of thing that we, as business owners, should require of our employees, but that's our business, not the IRS' business, I believe.

So in conclusion, I dislike most of the Treasury plan except for the $2,500 IRA deposit, which I think is healthy. Some combination of the Kemp-Kasten and Bradley-Gephardt looks better to me, the simpler one.

I would like to say keep it simple, realistic, and fair.

Senator **Sasser**. Thank you very much.

Mr. Bolton.

STATEMENT OF DEWAYNE P. BOLTON, CHAIRMAN, ECOM SYSTEMS, INC.

Mr. **Bolton**. Thank you.

I guess acting as a small businessman, the first thing I'd like to do is confirm that the cost of the travel here by automobile was a business expense, and I think we've got that confirmed by the committee.

Senator **Sasser**. Well, I'll be prepared to execute an affidavit, if that's necessary.

Mr. **Bolton**. Thank you, Senator.

My name is Dewayne Bolton and I serve as chairman and cofounder of ECOM Systems, Inc., of Memphis, TN. We are a distributor of computer hardware and software to financial institutions, primarily to credit unions. We have installations installed throughout the United States in approximately 35 States. Our clients range from installations in Alaska to New England, from Florida to California. We were organized as a Tennessee corporation in 1974 and received the first Small Business Award for firms between 1 and 25 employees in competition sponsored by the Memphis Journal in 1981. We now have approximately 45 employees, so we have increased and grown as a small business.

Now, let me commend, first of all, the Subcommittee on Tax Reform and Simplification and the Senate Small Business Committee for holding this hearing. I appreciate the opportunity of appearing and expressing certain concerns regarding recent tax reform and simplification proposals.

The two areas that primarily concern me are the capital gains proposal and the changes proposed in the accelerated cost recovery system. Before discussing certain of these selected items, I would like to comment, first of all, on the general concept of simplification.

In my opinion, I don't believe—and I think it's verified by the other people that testified here today—that anyone would disagree that there is a need for simplification; not only needed, but it's long overdue. The complexity of the current tax system is a burden on individuals and a burden on the small businessman. Neither has the resources, either the small businessman or the individual, to take advantage of many of the special circumstances available for tax deferral or tax reduction. It is my hope that the committee, the research groups, and especially the lawmakers who must make the decisions concerning these tax issues will keep in clear focus the importance, first of all, of simplification.

The following comments regarding the U.S. Treasury plan for tax reform and simplification are based upon a personal observation and an analysis of the limited material that we've had available in the last few weeks.

My greatest concern is the effect of the proposed changes in the capital gains tax. The proposed plan of repealing the 60-percent exclusion in effect will raise the capital gains tax 75 percent. The move from an effective rate of 20 percent to 35 percent, I feel, will produce a negative effect on small businesses' ability to raise equity capital.

The small businessman faces difficulty in obtaining debt financing to fund a growth situation. If the business happens to be in the service industry, the task is much more difficult. In a service-related company growth funding is normally used for personnel expenses. Most financial institutions require more tangible security than would be provided by a business plan for increase in personnel. This forces most of the service companies to turn to the venture or equity market to fund their growth.

Under the proposed Treasury plan of treating capital gains as ordinary income, I feel it places the small business in a position of having to compete unfairly with the larger, more established corporations. There is a higher risk in investing in a small business. Therefore, the rewards should fit the risk.

The equity or venture market may afford the only alternative available to a small business that wishes to grow. I ask that serious consideration and study be given to this provision before enactment.

Adding 75 percent to the potential tax through the capital gains proposal would prove a disincentive for those who wish to start firms, or planning to sell them in the future. An entrepreneur thinking of starting a business must make sacrifices and take very serious risks; yet, under the capital gains proposal, his potential rewards face a tax increase of 75 percent. And frankly, our Government and Nation can ill afford to hamper small businesses.

New small businesses have created most of the new jobs, rather than the large corporations. Historically, small businesses have also provided growth and helped reduce unemployment.

Also—and this is opinion—most innovative developments have been derived from small businesses——

Senator **Sasser**. Mr. Bolton, if I may interrupt you, that's not just opinion. You can find objective data to substantiate that statement.

Mr. **Bolton**. Thank you, sir.

The dedication, drive, and motivation of an entrepreneurial-run business have made our country great. I feel we can ill afford to tamper with a system that has worked so well.

The other concern on which I would like to comment briefly is the proposed repeal of the accelerated cost recovery system and proposed direct costing of equipment. Although I do not have the specific details of these proposals, it appears that either, if enacted, could provoke a negative impact on one portion of the high-tech industry, the computer vendor business which we're in.

The economic life, using a computer as an example, is highly dependent upon the company in which it's used. A high growth firm may want to write down a system faster than a more mature company, which may plan to use the system over a much longer period of time. It is important, I feel, that the cost of equipment be charged on a basis consistent with the useful life of that particular equipment.

Thank you, Senator, and members of the committee, for giving me the opportunity to present my views today.

Senator **Sasser**. Thank you very much, Mr. Bolton.

Mr. Toma, do you have anything to add today?

STATEMENT OF JOHN TOMA, ALDRICH INVESTMENT CORP.

Mr. **Toma**. Yes, Senator, I would like to take a few minutes. I would like to add my welcome to those of the other witnesses to you and your staff here in Memphis——

Senator **Sasser**. Thank you.

Mr. **Toma** [continuing]. And I'd like to apologize that I am having to stand in for Lyman Aldrich, who is my partner and also the president of our company. He was taken ill just before lunch. I would like to further apologize that I had to hastily scribble together some notes during lunch to get prepared for this. Lyman is a very good extemporaneous speaker, so he didn't have any notes prepared that I could even start with.

By way of introduction, I am the senior vice president of our company. We are a 5-year-old, Memphis-based business; we have spent a great part of the last several years very heavily involved in the renovation and redevelopment of properties in downtown and midtown Memphis. We have now expanded into New Orleans and also into Nashville, where we also have acquired urban property which we will probably convert to some form of residential property.

As an owner and a manager of a small business and, more particularly, a small business which is involved in the development of urban real estate, I really, after reading the Treasury proposal, am beginning to feel that we have been singled out for execution. Many of the projects that we are currently involved in, including some which we completed in 1984, simply would not have been done had it not been for the investment tax credit and had it not been for ACRS.

Senator, to give you just a brief feel for the amount of real estate that we're involved in, I'm going to run down very quickly some projects that we're currently doing in downtown Memphis. I apologize for this litany, but I think it might set the stage so that everyone understands what I'm talking about.

We have just completed the development of a building in downtown Memphis called the William Len, which was an old hotel. It stood vacant for approximately 15 years. Perhaps people in this room remember that a year or two ago it had no windows; it was a nesting place for pigeons and, occasionally, the winos would break in and spend the night there.

Largely due to our interest in downtown and the fact that downtown Memphis is certainly in a comeback phase, and due more specifically to the availability of the historic tax credit and also to the ACRS provisions of the Tax Code, we have, over the last 18 months, turned that into a building which is worth approximately $8 million. We paid approximately $800,000 for it; we put some $6 million in it. It is now a viable piece of real estate. We will start renting in a month or so. It will be the home for some 90 people who choose to live in downtown Memphis.

We also—again, this is a brief list—own the old Exchange Building; we own Memphis' arcade—every downtown area has to have an arcade, and we own the one in downtown Memphis. We have a large lot on which we are contemplating building a new parking garage to service the Exchange Building, which will also be a residential property, and the arcade, to which we hope to attract first-class restaurants or retail tenants. We have the old Gerber Department Store, which is across from Court Square; it will be developed, hopefully in 1986, into a mixed-use residential and retail building. We have the old Brodnax Building, which is located across Mid-America Mall from the William Len Building; and I could go on.

There are several others. All of these buildings were acquired in an unrenovated, abandoned, unoccupied state. The value of that real estate, or at least what we paid for it—and this includes a couple of buildings I didn't mention—is approximately $4.5 million. If we go through with our development plans on all of that real estate in 1985 and 1986, that property will have a projected value of $45 million. That is comprised of both debt and equity. It will bring some 500 additional living units into the downtown area and some—I'm guessing—500,000 to 700,000 square feet of—watch out——

[Flag behind Senator Sasser topples.]

Senator **Sasser**. I think we're being singled out for execution here. [General laughter.]

Excuse me. Go ahead.

Mr. **Toma**. I didn't do that, really.

I guess the point of going through all that is simply to say that in an area of Memphis which comprises something like 25 percent of the tax base of Shelby County, largely due to two provisions of the Tax Code that we have finally learned how to utilize after a couple years of trying to figure this out, we are looking at, in a 24-month period, adding some $40 million to the value of the properties we own in downtown Memphis. This obviously—and again, we could go on and get into great detail about how many jobs this creates; just on the William Len alone, one of our local construction companies had a $4.0 million contract that kept them busy for 12 months; and of course, you can multiply that times the number of projects that I have just mentioned. You could talk about the long term effect on the county's tax base and, again, it would take someone probably smarter than I am to project that out and talk about what that's worth.

All of this is really preparatory to talking about the importance of the investment tax credit to us as real estate developers and of the currently constituted ACRS provisions. We enjoy doing downtown renovation projects. We like the way they look; we're artistic enough to appreciate the fact that it's possible to take a building built in 1929 and bring it back to some semblance of its past splendor; there are some esthetic rewards that go along with this. I'm going to leave that to the preservationists. I think I just want to talk dollars and cents here in the remaining time that I have.

Before that, I think two other things really need to be mentioned. One, we're going through right now what we think is a very difficult time due to what I would call the "tax scare" period. We found it very hard toward the end of 1984, and I think we're going to find it extremely difficult in 1985, to raise the equity dollars that we need for these properties. People just don't know what's going to happen, as we sitting here don't know what's going to happen; and with no certainty about what the tax law's going to be in 1986, people are very reluctant to commit their dollars on a going-forward basis to projects in 1985. That is going to hurt us and it's going to hurt our efforts to develop these properties in which we have invested our own equity dollars.

It makes it almost impossible for us to do any kind of forward planning for our own company. We know that we have to develop the properties that we own now if we're going to take advantage of the ITC and, again, the ACRS. But even if we're going to be "grandfathered" in, that is, if in fact those two provisions are changed, it's very hard for us to figure out what we should be doing in 1986.

We are in a leadtime business. We have to acquire property months in advance of the development of that property; there's something like an 18-month average leadtime on one of our developments. So we have essentially called our acquisitions people off. We have laid them off, we have sent them home, we have put them to doing other things. We are in a position now where we are afraid to acquire additional property because we don't know what we'll be able to do with that property when the time comes to develop it, which will be 1986. I'm sure I'm not alone; I'm sure you will hear that from a number of real estate developers.

I guess again, before getting down to economics, the other thing that has caused us great, great concern—and I have heard this mentioned here several times today—is that the uncertainty of all this is very disconcerting. We have learned somehow to live with the provisions of three tax acts in the last 4 years. We have brought our first project to completion this year utilizing the historic investment tax credit and provisions and the accelerated cost recovery system. It took us over a year, I'd say probably close to 2 years, to figure out how to use those tools in a way that was meaningful to us as developers and to our equity investors. Now, finally, having learned how to do that, I think we're seeing two projects this year come out of downtown Memphis: The William Len project and one of our competitors redoing the old Scimitar Building, that utilized the ITC and the ACRS.

The reason you're seeing those projects come onstream now is because it has taken us that long to figure out what the legislation, which allows those, means. I'm not sure at all that I agree with what's been said here today about the Tax Code having to be simple. The criminal justice system is not simple; the Securities and Exchange Commission regulations are not simple; the FTC is not simple; life is not simple. I think that the Tax Code needs to be certain, and not necessarily simple.

Again, let me move on quickly into what I think the economics of this are, and then I will close. I am taking a little more time than I had planned to, and I apologize for that.

What happens in these real estate deals, these real estate developments, is that, as everyone knows, they're made up of a debt side and an equity side; and on the debt side you don't have a whole lot of control over what the cost of money is. The cost of money is what it is on the day that you try and put the transaction together. So you're going to pay your lender 12 percent, 13 percent, 14 percent, whatever it is. The only things that you can really control are your costs. Everyone knows the costs of building are high and they're not likely to go down. At the same time you are faced with a situation that people can only afford to pay so much rent. I'm talking now in terms of multifamily housing. You really can't push the rents beyond what people can afford to pay. You then come down to the equity investor. Somehow, out of all that, you have got to earn him a return or he won't give you his money; he'll put it somewhere else.

Some very quick calculations done this afternoon—and I hope to elaborate on these and send them in as part of the record within the next few weeks—tell us that if we took the investment tax credit out of this William Len project that we just talked about, we would have probably—it's based on time value of money—cut the return to the investor in half. It probably would have been worse than that; that was a rough calculation. When you're talking about a project which, in all best events, will probably yield the investor about 25 percent per annum over the 10 years that he's involved in it or projected to be involved in it, and you plug in the high risks of real estate and all the other factors that go along with it, if that return is then reduced to 12 percent or lower, people are simply not going to put their money in these ventures. I think that's not very hard to understand.

I guess the question that has to be answered is, Why is that important and what's going to happen if these vehicles are taken away or eliminated? This is an opinion, and an opinion only, but it is based upon quite a bit of thought. I think that really it's going to be largely fatal to what is now going on in an area like downtown Memphis. I think that you're going to see that the economics of the transactions require some maturing, and that is to say that when you build a project like our William Len project you really don't expect the rents to produce a cash flow for 4 or 5 or even 6 years. In other words, you're taking the risk that rents can go up and operating expenses can come down, and that ultimately you can earn a return on your money. Of course, what the tax credit and/or ACRS does is allows you that time to kind of grow that investment to maturity. It compensates for the lack of cash return that the equity investor would get if he put his money in a CD or whatever else. If that is taken away from us, I can say, speaking from our company's point of view, we have already started, based on this that I'm calling the tax scare period, we have already begun to look for other things to do with our company because we do not think we will be able to entice investors into projects like the ones that we are used to doing.

I think that if you take this out of the downtown context for a moment, you are going to see apartment building largely stopped across the country for the same reasons that I have just mentioned. These projects do not produce sufficient cash flow to pay the debt service, much less provide an equity return for the first given number of years, however the project is structured. It would be difficult for an apartment builder to compete for equity dollars if he is not given the benefit of, again, some of the tools that are now within the Tax Code.

I think the corollary to that is that you will see rents going up dramatically in existing properties, and any properties which are developed currently will have to be developed at outrageous projected rents because something has to give somewhere. Somehow, the lender has to get his yield and the equity investor has got to get his return; and the only way that's going to come out is in dramatically increased rents over the first several years of the property.

One last thing in closing, I think we're dealing here also with a question of, I guess I would just call it basic equity. And again, I take our company as an example. Based on the tax law as it now stands, we have invested in downtown Memphis alone $4.5 million in properties that we think we can develop into economically sound ventures using the ITC and the ACRS. We bought these properties based on the fact that that was the law, that this was the Tax Code. These properties will not all be developed in 1985; some of them, of necessity, have to go into 1986 just because there's a limit to how much any company can do in any one year.

If the ITC is eliminated effective January 1, 1986, we are basically going to be stuck with some real estate that we can't do anything with. I would suggest, No. 1, to alleviate that problem for people like us, and No. 2, to allow people like us to be able to plan our next several years—and as you well know, Senator, planning is an integral part of the business process—so that if certain items like the ITC are going to be eliminated and the ACRS is going to be converted back to a "useful life" concept, I would suggest—in fact, implore you—to do that on a "going forward" basis, to phase into these kinds of changes and not have them all happen in one fell swoop in 1 year.

Thank you very much.

Senator SASSER. Well, thank you, Mr. Toma.

[Subsequent information was received and follows:]

ALDRICH INVESTMENT CORPORATION
REAL ESTATE INVESTMENTS & BROKERAGE

January 30, 1985

The Honorable Jim Sasser
United States Senate
Russell Senate Office Building
Washington, D.C. 20510

VIA FEDERAL EXPRESS

Re: Memphis Field Hearing
Committee on Small Business

Dear Senator Sasser:

I would like to thank you for inviting Aldrich Investment Corporation to testify before your field hearing on proposed changes in the Internal Revenue Code. I have just received a transcript of my testimony, and will make the appropriate corrections and return this testimony to your committee.

In an effort to bring my general comments to your committee into sharper focus, I asked our staff to prepare the enclosed analysis.

As you know, our company has just completed the restoration of the old Wm. Len Hotel in downtown Memphis. This twelve story structure stood vacant for fifteen years prior to acquisition and restoration by our firm. It is now eighty-nine beautifully appointed apartment units, which we will put on the market in spring. Thus, a vacant and potentially dangerous structure has been put back into productive use, generating revenues for the community, and generally adding to the continuing renaissance of downtown Memphis.

In my remarks before your committee, I stated that this project would not have come to fruition without the tax incentives which were utilized to attract the necessary debt and equity funds. The summary enclosure shows dramatically why this statement is true.

Prudent investing of funds is a matter of gauging potential return as against the possible risks. One way that real estate developers have used to convince equity investors to place funds in their projects is through a computation of the Internal Rate of Return (IRR). This concept allows the investor to compute his annualized potential rate of return on dollars invested. It produces a number which is meaningful only in a relative sense in that it can be placed side-by-side with the potential IRR of other projects. One central assumption to the IRR concept is that the real estate will appreciate in value over time.

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We have found that to attract equity dollars to what are percieved to be "high-risk" investments in multi-family projects in urban areas, we must offer an IRR of in excess of 25.0%, assuming an annual rate of appreciation of the real estate of not more than 4.0%.

With this brief introduction, I would ask you to review the attached summary sheet, which graphically shows the effect of certain proposed revisions in the tax law on a project like the Wm. Len.

Please look at the line which we have highlighted, indicating the IRR at a 4.0% annual rate of appreciation on the real estate. You will see that the original structure of the investment produces a potential IRR of 30.13%. Progressing across the page, you can see how this potential IRR drops as each of the tax related elements are removed. The removal of the 25% ITC drops the IRR to 12.18%. The removal of the façade easement donation drops the IRR to 24.03%. The extension of the depreciable life of the building to forty years drops the IRR to 17.24%. Reducing the maximum tax rate to 35% drops the IRR to 21.27%. The next column shows that if all of these tax incentives are removed from the investment, the potential IRR to the equity investor is 6.05%.

You will note that the removal of each incentive is severely damaging to the investors' expected rate of return, and the removal of all of these incentives is obviously fatal to the project. Stated more simply, we would not be able to attract large amounts of equity capital for these urban adaptive reuse projects if the maximum potential IRR we can offer to the investor is less than what he can earn in a government-backed certificated of deposit or a Treasury Bill.

Perhaps even more dramatic is the final vertical column of the analysis. This column shows that to achieve an IRR of 29.87%, assuming that all of the tax incentives are removed, would require that rents in the Wm. Len project be doubled. Accordingly, a standard one-bedroom/one-bath unit which will rent for $350, would have to rent for approximately $700 to provide a comparable IRR to an equity investor. It can thus be readily seen that without the current tax incentives, capital formation for urban adaptive reuse projects will be virtually impossible without tremendous rental increases. Since most people cannot afford to pay these kinds of rents, projects such as The Wm. Len will be totally infeasible if the tax incentives are removed.

I have failed to mention two other aspects of the Wm. Len project which are tax related. First, we are able to "freeze" property taxes on redevelopment projects in downtown Memphis through the Center City Revenue Finance Corporation. This reduces the annual operating expenses of the property during the early years, allowing the projects to pay reasonable yield to the debt lender. This "tax freeze" would probably be unaffected by proposed federal tax law changes. Second, The Wm. Len has been financed through a tax exempt bond issue, again through the Center City Revenue Finance Corporation. All of the current tax reform proposals call for the abolition of all so-called "private purpose" tax exempt bond financing. Without the ability to utilize tax exempt bond financing, it is extremely unlikely that the economics of the Wm. Len project would have been workable.

Thank you again for allowing us to testify before your committee on these matters. We urban real estate developers have learned how to live with tax changes over the past few years. However, it is our opinion that the proposed legislation will largely obliterate the type of developments which we have been doing. The impact of this upon cities like Memphis, which is just beginning to show signs of life after a long and deep depression, probably need little further elaboration. I would urge you to take a hard look at the various plans which are being promoted as "tax simplification." I believe you will find that little real thought has been given to the impact of these proposed changes on businesses such as ours.

Finally, I would like to say that we at Aldrich Investment Corporation would welcome any opportunity to provide you or other members of your committee with input on the potential effect of this legislation. We are available at any time to meet with you to further explain our grave concerns about the effect of this proposed legislation on our segment of the real estate industry.

With warmest personal regards,

John E. Toma, Jr.
Executive Vice President

JETjr/mbm

Enclosure

cc: Mr. Steve Gravenstein

New William Len, Ltd.
Analysis of Effects of Various
Tax Proposals Currently Before Congress
29-Jan-65

	Original Structure	Less 25% ITC	% Difference	Less Facade Donation	% Difference	40 Year Building life	% Difference	35% Tax Rate After Year 1	% Difference	All Incentives Removed	% Difference	All Removed + Gross Income X 2.0	% Difference
Annualized Income	551,040	551,040	0.00%	551,040	0.00%	551,040	0.00%	551,040	0.00%	551,040	0.00%	1,129,632	105.00%
Total Equity Raised from LTD. Partners	3,289,610	3,289,610	0.00%	3,289,610	0.00%	3,289,610	0.00%	3,289,610	0.00%	3,289,610	0.00%	2,205,538	-32.95%
Maximum After Tax Investment	968,167	1,808,955	86.84%	1,095,011	13.10%	1,380,030	42.54%	1,323,001	36.65%	2,799,355	189.14%	925,342	-4.42%
1st Year Write Off	2.49	1.15	-53.82%	2.21	-11.24%	2.39	-4.02%	2.49	0.00%	0.61	-75.50%	0.62	-75.10%
Lifetime Write off	1.69	1.30	-23.08%	1.67	-1.18%	1.19	-29.59%	1.69	0.00%	0.63	-62.72%	-2.58	-252.66%
Internal Rate of Return (Foreclosure)	2.95%	-6.56%	-322.37%	2.27%	-23.05%	-9.03%	-406.10%	-4.07%	-237.97%	-12.07%	-509.15%	25.14%	752.20%
IRR 2% Appreciation	24.26%	8.48%	-65.05%	19.39%	-20.07%	12.04%	-50.37%	16.07%	-33.76%	2.38%	-90.19%	28.06%	15.66%
IRR 4% Appreciation	30.13%	12.18%	-59.58%	24.03%	-20.25%	17.24%	-42.78%	21.27%	-29.41%	6.05%	-79.92%	29.87%	-0.86%
IRR 6% Appreciation	35.66%	15.55%	-56.39%	28.25%	-20.78%	21.91%	-38.56%	26.01%	-27.06%	9.40%	-73.64%	31.71%	-11.08%
Modified Internal Rate of Return (Foreclosure) (using 8% discount rate & 8% Reinvestment rate)	6.76%	-0.36%	-105.33%	5.86%	-13.31%	1.52%	-77.51%	4.03%	-40.38%	-5.94%	-187.87%	20.06%	196.75%
MIRR 2% Appreciation	14.12%	8.35%	-40.86%	13.91%	-1.49%	10.08%	-28.61%	11.71%	-17.07%	3.56%	-74.79%	22.95%	62.54%
MIRR 4% Appreciation	16.79%	11.14%	-33.65%	16.73%	-0.36%	12.97%	-22.75%	14.42%	-14.12%	6.43%	-61.70%	24.78%	47.59%
MIRR 6% Appreciation	19.36%	13.81%	-28.67%	19.43%	0.36%	15.69%	-18.96%	17.02%	-12.09%	9.14%	-52.79%	26.67%	37.76%
Cash Flow Year	1990	1990		1990		1990		1990		1990		1986	

Senator **Sasser**. We've been told the Tax Code ought to be simple, we've been told it ought to be equitable, but judging from your testimony, we also ought to add the word "certain" to it. So simple, equitable, and certain. And if you were choosing between simple and certain, I presume, Mr. Toma, you would choose certain, judging from your testimony.

I've got a lot of questions I'd like to ask you but I cannot. Unfortunately, I'm scheduled to be in Millington to make a speech there at 5 o'clock, so we're going to have to burn up the road to try to get over there. But we may want to propound some questions to you in writing, and if you would be kind enough to respond to them, we'd appreciate it.

I might say this in closing. Mr. Toma, I find that almost all of our small business people who are in the real estate business or the real estate development business look upon this new proposed tax legislation with not much eager anticipation. They're generally pretty negative on it. And I think it is a sad state of affairs when we change the tax laws four times in 4 years. Someone said one time that "tax laws are like sausage; no one should see them in the making or you couldn't stomach them." And that is indeed the case with the way we put together these tax laws in the Congress, and the administration has to bear a substantial portion of the responsibility. But we do need to have tax laws that are certain. You can't do any planning if you're going to be changing the tax law, every year.

Having said that, I want to thank all of you for coming today and participating in these hearings. I have an ongoing and profound interest in small business. As I said in the opening statement, I think that is the backbone of our economy. And Mr. Bolton, that's not just an opinion. You and I can find objective data to substantiate that. Small business does create the jobs; it does provide the ideas; it is the innovative cutting edge of this economy, and in my judgment, it's the last refuge of the true entrepreneur.

We in Government must be very careful that we don't do something to snuff out this very vital component of our economy.

Thank you very much for coming and I want to assure you that this testimony will be read with interest when it's transcribed. If anybody would wish a copy of it, just let us know and we'll send you voluminous volumes of it.

Thank you very much.

[Whereupon, at 4:35 p.m., the committee recessed, to reconvene at the call of the Chair.]

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

WEDNESDAY, FEBRUARY 13, 1985

U.S. Senate,
Committee on Small Business,
Sioux Falls, SD.

The committee met, pursuant to notice, at 9:02 a.m., in the Morrison Commons Lounge, Augustana College, Sioux Falls, SD, Hon. Larry Pressler (acting chairman of the committee) presiding.

Present: Senator Pressler.

Staff present: Stewart J. Hudson, professional staff member; Lawrence G. Dalsin, professional staff member; Tom Walsh, tax counsel, and Tom Hohenthaner, professional staff member, office of Senator Pressler.

STATEMENT OF HON. LARRY PRESSLER, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator **Pressler**. Let me begin by welcoming you here and saying that this is a hearing on taxation policy affecting agriculture, small business, and individuals wherever it is relevant, but mostly looking at the agricultural aspects.

As you know, we are experiencing a great crisis in agriculture and some of the tax matters that we are going to be talking about sound very technical. There is the investment tax credit. There is the depreciation of equipment. There are reporting requirements. But these things become very important to a small businessman, farmer or individual.

There are at least three tax proposals that supposedly will simplify the Tax Code, and close to 60 percent of all Americans say that they would like to see the Tax Code simplified. But, on the other hand, there are many industries and individuals that benefit from current tax law, and some investment is actually encouraged by the traditional Tax Code.

Today we have some really outstanding witnesses. I am going to, first of all, call on some experts from the Small Business Committee to give a very brief overview of the three flat rate taxes that have been proposed.

I know that upon first hearing about it everybody is in favor of a flat rate tax because, generally, it sounds very good. But we have got to be extremely careful in determining how these proposals would affect farmers, ranchers, and small business owners.

I will be taking what we learn today back to the Small Business Committee, on which I serve, and we will be making recommendations to the Finance Committee. The Finance Committee will send the tax reform proposals to the Senate floor. More importantly, however, the IRS ultimately issues regulations, and I am constantly writing letters to the Internal Revenue Service about some of the tax regulations.

For example, last year Senator Dole led a movement to pass a bill to tighten up some of the loopholes in the tax law. The IRS implemented an extensive recordkeeping requirement for small businessmen and anybody who uses a vehicle part time. It has been estimated that it will cost small business $3 or $4 billion to do the reporting.

So the point that I am making is that hearings such as this are really the work of Congress, the day-to-day detailed tax writing. What has happened is that the Tax Code has become so onerous that only a few well-trained lawyers and accountants can fully understand it; 40 percent of all Americans need professional help to do their tax returns and virtually all businesses, corporations, and farmers need such help.

In fact, we have here today one of the finest lawyers in our State, Jim Moore, who not only has a law degree but a master's degree in tax from New York University. He is the kind of an expert that I look to for advice when these tax issues come up because he deals with farmers and small businessmen in South Dakota every day as a practicing lawyer. We also have some farmers and small business owners on the panel.

Let me say at the outset that I was in Pierre yesterday at the farm crisis meeting and I certainly hold these hearings with full understanding of the great problems that agriculture faces. I will shortly have the pleasure of welcoming the South Dakota State Legislature to Washington. I have asked my office to start the machinery to request a meeting with the President and Vice President as well as some of the leaders of the Senate and the Department of Agriculture. I will do everything in my power to make their visit have a great impact.

We have a great deal of work to do in this Congress. There have been a number of budgetary proposals. Our first budgetary resolution is due out May 15 and we are working on that, but also we are working on major tax revision. Senator Packwood is the new chairman of the Finance Committee. He has come out very much in favor of retaining the tax-free nature of some of the benefits that corporations and others can give their employees because he feels that if they didn't provide them, the Government would have to provide them. That is one of the kinds of issues that we face.

There is a whole range of issues. I have with me some experts from our committee. Tom Walsh, Larry Dalsin, and Stewart Hudson are here from Washington to hear the testimony.

But, first, I am going to call on Stewart Hudson for just a brief time before we call on Jim Moore just to summarize the tax plans that have been presented so far this year.

Stewart.

Mr. HUDSON. As the Senator said, I am a staff member of the Small Business Committee, and I really wish he wouldn't have used the word "expert," but we will do the best we can.

We have these charts here, which I know are very difficult to see. That is why we have got a handout here that is essentially what appears here.

We have heard from a number of the witnesses that are scheduled to appear today that they also do not consider themselves experts, and that is in effect not exactly what we are trying to do here today.

This is very complex going through all three of these major proposals and going through current law. In fact, we are just trying to keep up with the changes that are made in a lot of these proposals. And as an example, just last week I believe the Kemp-Kasten proposal was reintroduced and some minor changes were made in it. That won't affect any of your testimony, but I just point that out to say that we really are going to have a low-key hearing in the sense of expecting everyone to be an expert.

Another thing I would like to point out is something the Senator touched on which is how soon would these proposals be acted on. It is likely, even though it is second on the President's agenda, that the first thing the Congress is going to do is try and attack deficits.

So we do have some window of opportunity to comment and debate these proposals, which is why this hearing is so important. So we will take what we hear today and go back to Washington and make the changes that are necessary to come up with good tax reform, if that is in fact what we want to do.

So we have our three charts here. As the Senator touched on, all of these proposals, all of the various proposals consist of both desirable and perhaps undesirable provisions.

For example, on the first page here we have a page called tax rates. Now when each of these so-called flat tax proposals is introduced, the reduction in corporate and individual tax rates is offered as a sweetener, and what it offered to sweeten against is the medicine which is the loss of credits and deductions. So keep in mind here that everything is a balance.

With regard to the rates and the so-called flat tax, you look on your chart and you see that the Treasury proposal imposes one corporate rate, as does the Bradley-Gephardt, but the Kemp-Kasten proposal proposes three corporate rates. You go to the individual side and you find that the Treasury proposal and Bradley-Gephardt have three individual rates and Kemp-Kasten has only one rate.

Now if that is confusing to you, it is confusing to me, too. So it is not always a flat tax even though it is offered that way. There are a variety of tiers in many of these proposals.

The other thing to keep in mind with regard to rates is if you are a small business or a farm, that you are either taxed as a corporation, which means you are going to pay these rates up here, 33, 30, or 35 percent, or you are going to be taxed as an individual which means you pay these individual rates down here. So in evaluating these proposals, that is something that every small business person or farmer will keep in mind.

There are some other things on this chart. Corporate dividends was a provision that was in the original Treasury proposal which was offered as another sweetener which would give corporations a tax deduction for dividends they pay out.

I just mention that. You can go through it later if you want, but that may not last when they offer their proposal to Congress.

Let me say at this point that I know a lot of you are going to have questions. To the extent possible, we will be around for the 5 minutes or so we have after this hearing to try and answer some of those questions. So just bear with me here and hold on to those questions.

Another thing we have here on tax rates is a provision that is very important to farmers, which I will go back to later in this summary, and that is capital gains. This is not a sweetener, but it is a proposal in all of these reforms to either eliminate or reduce the preferential treatment on capital gains. So I will point that out and come back to it.

Now we go to credits and deductions. This is the medicine, the castor oil or whatever. This is where the simplification part comes in. The most important credit, or one of the most important credits that is going to be eliminated by all three major reform proposals is the investment tax credit. Since I don't have much time, I won't go into it too deeply, but I will just point out that that I think most everyone would consider a negative if they use it, if they use the investment tax credit.

Senator **Pressler**. Has everybody got a copy of this?

Mr. **Hudson**. It has been handed out.

Senator **Pressler**. This is the same as the charts. If anybody is lacking it, we can give more of them out.

Go ahead.

Mr. **Hudson**. So this ITC here, investment tax credit, if you use it and it is repealed, obviously that would be a negative. But we get again back to our question of balance. Are the reduction in rates offsetting the loss of this credit. Again, this is an important farm provision.

Finally we get down to depreciation, the ability to write off the cost of equipment over its so-called useful life. All of these proposals to a greater or lesser degree would lengthen the so-called useful lives. The effect of that would mean that if you have equipment that you depreciate, you would be able to take smaller and smaller amounts per year than you are currently allowed to do.

And I point out that the three major reform proposals all go in the same direction but to a greater or lesser degree. The administration proposal and Bradley-Gephardt really slow down depreciation and Kemp-Kasten is pretty close to current law.

Another important provision, that is I think you put on the negative side perhaps if you use it, is the direct expensing that is currently in law which allows you, if you are a small business person, to write off up to $5,000 of the cost of depreciable equipment that you buy.

Now all of these proposals would somehow reduce the ability of small businesses to write off this expense. This directing expensing provision is probably the one small business provision in current law regarding depreciation. And, again, the loss of that direct expensing would have to be balanced against the rates.

There are some other things here which are minor, interest and accounting of inventories, and those are indicated on the charts that you have.

On other provisions, again we have a slew of things going on here. We have elimination of corporate charitable contributions or modification. We have the elimination of a rehab credit. Small minor tax credits are eliminated in an effort to simplify the code.

One I would point out that has drawn a lot of attention is taxation of fringe benefits, which just about any worker is concerned about, but so are small business owners. What they are talking about as far as taxing those benefits is health insurance premiums, life insurance premiums and the like.

I said I was going to go back and talk about the overall scheme of things here with regard to farms. For the purposes of this hearing, I think we would consider family farms certainly a small business. And there are provisions in all of these reform proposals that have the potential to affect the family farm. Now I stress potential because, as I said earlier, we have been trying to keep up with all the changes that are made in these proposals. They change almost weekly it seems. So we don't know what the final version of a lot of these proposals will be and, in any event, we have a number of months before the Senate will actually consider this.

But let me point out five provisions that are of potential interest to farms. We get back to interest expense on the credits and deductions page. That is page 2.

Currently a number of farms, and I guess just about every farm borrows money, and when you borrow money you have to pay interest and that is deducted as an expense. All of the proposals would retain the deductability of that expense. No one is going to take that away.

There is one minor provision in the Treasury proposal that would adjust the interest expense for inflation. That could be pretty confusing, but the net effect of it would be to reduce the amount that you are able to deduct for interest expense.

Another provision that is of great concern to family farms is property taxes. Everybody pays property taxes on either your farm property or as an individual. For today we will concentrate on the property taxes on your business property, your farm property, and all of the proposals would retain the deductability of property taxes for your business or your farm. So rest easy on that one and I would say on interest expense.

Now the fun stuff is depreciation of farm property. A number of these proposals, because they lengthen depreciation, lengthen depreciation for farm property in particular. Therefore, if you were able to write off a tractor over 5 years, you might find under these reform proposals that you can only write it off over 10 years. The net result would be that you would be able to write off less per year. Overall you would be able to write off the same amount but less per year.

Again, the investment tax credit. If you buy a tractor or invest in a tractor, right off the top generally, if you are eligible, you can take a 10-percent credit from the purchase of that tractor. You all know what it means if they take away the credit. It is something like a 10-percent increase in the cost of that equipment.

The final provision, which is probably the most crucial for farms and farmers is the capital gains provisions that are in all of these proposals. Now currently if you sell, if you decide to move to Florida or something and you sell your family farm, that is treated as a capital gains generally and it is taxed at a lower rate than if you were just making wages or something.

What all of these proposals would do is eliminate that preferential treatment. The net result would be a higher tax when you sell you farm property. However, again I point out, you balance that against the rates and you may come out better. And point two being that these proposals are in a state of flux.

The administration's proposal originally eliminated the preferential treatment for capital gains entirely. Since that time they have heard the screams from out here and I think they are going to come off that proposal a bit. But, nevertheless, those are the things to pay attention to as farmers, interest expense and property taxes, which I don't think will be major problems, depreciation, the investment tax credit and capital gains, which may be significant problems in all of these reform proposals.

So that is all I have to say and I will turn it back.

[The charts referred to follow:]

TAX RATES

Present Law	Treasury Department Proposal (TD)	Bradley-Gephardt Proposal (BG)	Kemp-Kasten Proposal (KK)
Corporate Rates			
Graduated rate structure (15%, 18%, 30%, 40%, 46%)	Repealed	Repealed	Modified, 15% 25%, 35%.
Maximum rate (46%)	33%	30%	35% above $100,000
Individual Rates			
Graduated rate structure (currently 15 rates)	Replaced, 3 rates: 15%, 25%, 35%	Replaced, 3 rates: 14%, 26%, 30%	Replaced, flat rate of 24% with exclusion of up to 20% of $40,000
Indexed, beginning in calendar year 85	Retained	Repealed	Retained
Corporate Dividends			
No deduction for payor corporations	Allow corporations deduction for 50% of dividends paid	Retained	Retained
Capital Gains (long-term)			
60% excluded from income for individuals	Repealed-gains taxed as ordinary income	Repealed-gains taxed as ordinary income	Replaced-40% exclusion, or indexing of basis, allowed
Alternative flat rate of 28% allowed for corporations	Repealed-gains taxed as ordinary income	Repealed-gains taxed as ordinary income	Replaced-flat rate of 20% on corporate gains or, indexing of basi allowed
Indexing of basis for individuals and corps. not allowed	Indexing of basis of capital gains is allowed	Retained	Indexing of basis allowed alternative to given rate (Se above)

CREDITS AND DEDUCTIONS

Present Law	Treasury Department Proposal (TD)	Bradley-Gephardt Proposal (BG)	Kemp-Kasten Proposal (KK)
Investment Tax Credit (ITC)			
Generally, ITC=10% investment in depreciable property (limit of $125,000 a year for used property)	Repealed	Repealed	Repealed
Depreciation			
ACRS (Accelerated Cost Recovery System)	RCRS (Real Cost Recovery System); Basis indexed for inflation; fixed rate depreciation	Modified ADR (pre 1981 depreciation system); 250% declining balance	NCRS (Neutral Cc Recovery System) modified ACRS; Basis indexed fc inflation; allow current deprecia tion accounting methods
Direct Expensing			
Optional expensing of first $5,000 of depreciable business property (scheduled increases to $10,000 by 1990)	Retained, scheduled increases repealed	Repealed	Retained
Interest Expense			
Not indexed, some limitations	Indexed, further limitations	Deduction of non-business interest limited	No deduction for consumer interest
Accounting of Inventories			
LIFO conformity requirement	Repealed	Retained	Retained
FIFO	Indexed	No change	No change

OTHER PROVISIONS

Present Law	Treasury Department Proposal (TD)	Bradley-Gephardt Proposal (BG)	Kemp-Kasten Proposal (KK)
Tax-exempt IDBs			
Allowed, with strict limitations	Disallowed for private purposes	Disallowed for private purposes	Disallowed for private purposes
International Provisions			
Specific treatment of income from foreign subsidiaries	Modified slightly	Modified	Modified
Special tax status for FSCs (foreign sales corporations)	Retained	Repealed	Repealed
Fringe Benefits			
Generally tax-free	Limited taxation of medical insurance premiums, all others fully taxed	Limited taxation of medical insurance premiums, others fully taxed	Retains tax-free status of most benefits
Other Corporate Provisions			
10% limit on corporate contributions to charities	Modified	Modified	Retained
Allows certain miscellaneous business credits	Repealed	Repealed	Repealed
Other Individual Provisions			
Allows income averaging	Retained	Repealed	Repealed

Senator Pressler. Thank you very much.

I always tell students when I talk to them about the functions of a Senator that we are not always debating about foreign policy or listening to the President give a speech. Much of our work is very detailed committee work, like this, in which we deal with things which on the face you would wonder what impact they have, but the issues we will discuss today have a great impact on individual farmers and small business owners.

By the way, copies of the various testimony are available on the table behind the coffee and people who want copies of these three proposed tax reform bills, will find them there as well.

Let's call our first panel forward, which is Jim Moore, a partner in the firm of Moore, Rasmussen, Sabers & Kading; Eldon Johnson, a good friend and farmer from Hartford, SD, who has those pure bred Charlais; Burton Ode, a good farmer from Brandon, who has Holsteins I believe.

Could we get the three of them to come forward. I very much appreciate your time.

Jim, I know you have got a plane to catch. So we are going to hear from you first, but I want to thank all of you for being here.

I want to say to the witnesses don't be at all frightened by the technicality that Jim Moore can get into because there are very few people in the State who know more about taxes than he does, and we appreciate everybody's view.

In any event, I am going to call on Jim first and, Jim, I really thank you for being here.

STATEMENT OF JAMES E. MOORE, ESQ., PARTNER, MOORE, RASMUSSEN, SABERS & KADING, ATTORNEYS AT LAW, SIOUX FALLS, SD

Mr. Moore. Thank you, Larry.

I can assure you, Larry, I am not going to get very technical this morning, particularly about these new laws because I haven't had any great opportunity to review them. I have read them. That is, I have read some of the information that has been put out on them, particularly the comparison put together by Coopers and Lybrand, and I have also had some other material sent to me, particularly from your office. But what I have had has been limited, and this is my disclaimer as to not having any great expertise about these new laws. Everyone else has made that disclaimer this morning and I had better get it in, too.

I would like to comment on certain aspects of these bills with regard to their potential effect particularly on farmers.

First, I would like to point out that there is a genuine concern, and it was alluded to earlier by Stewart, among a number of taxpayers out there, that the so-called flat tax proposals will eliminate all deductions from income and not just the so-called nonbusiness deductions.

When they talk about eliminating interest and taxes and so forth, the farmers get concerned right away. They are really concerned about this I find in talking with them and I think there needs to be a clarification on it. They need to be reassured that they are still going to be entitled to all of the necessary expenses of doing business under section 212 of our code.

Now there are quite a number of proposals in here that would affect the taxes of farmers. I am going to comment on only a few and all of those have been alluded to already this morning.

First, I note that all three proposals eliminate the present 60-percent exclusion from capital gains. Capital gains affects farmers primarily in two areas, one, upon sale of their farmland and, two, upon sale of their draft, dairy and breeding livestock.

Capital gains are encountered most frequently on the sale of livestock, but the exposure is most dramatic when the farmer sells the land which he has held for many years at a greatly appreciated value, at least in terms of dollars. In fact, most of this appreciation results from inflation, which is the depreciation of our currency.

Since the land usually represents a large portion of the farmer's assets, the income tax arising from sale of the land can be very substantial even with the current capital gains provisions.

In some instances this discourages the passing on of the land by any other means than inheritance, where a new basis is obtained. And here the alternative minimum tax may deliver a double whammy catching an unwary seller by surprise and imposing an additional tax burden on this inflation generated income.

The alternative minimum tax was intended to tax the very wealthy who it was felt paid too little tax, but in my experience it has too frequently settled on the once in a lifetime transaction where the farmer or small businessman retires and sells out.

It is to the credit of both the Treasury and Kemp-Kasten proposals that they would index basis so that only real gains and not gains arising from inflation would be taxed. This might well create a preferable result for farmers even though the real gains would be taxed at ordinary rates, the reason for that being that so much of the gain in the farmer's farm and assets is inflationary, and if it were indexed to take that out, they might be better off in the long run.

One further point relating to capital gains: While it may be argued that higher taxes on capital gains may discourage risk taking, and this is one of the arguments against removing the capital gain provisions, I don't believe this factor would have much effect on farmers. Their motivations are otherwise. And of course the risk of flood, disease, wind and hail, among others, are much more real to them.

Since farming is a capital intensive business, the investment credit, which has been available since 1962, has been of great help in permitting the retention of capital for acquisition of necessary equipment and facilities.

All three proposals would repeal the investment credit. Repeal of the investment credit would have a definite adverse effect on the farm community, particularly at the present time when farmers are plagued by low prices, high interest rates and short capital. This provision of existing law is of continuing importance to them.

Recognizing, nevertheless, that repeal may occur, it is hoped that existing carryovers of unused credits may continue to be usable over a reasonable period of time.

Just a word of explanation there. Those investment credits that are not used in the current year when they arise from the purchase of new equipment can be carried back 3 years and forward for up to 15 years until they are finally used up.

So much has been said recently about the proposed new recordkeeping rules for cars and pickups that I won't belabor the point other than to say that I have rarely seen so much feeling and emotion over any tax issue. The feeling is strongly and almost universally held that the log-keeping proposal was far too burdensome—and the Senator referred to that earlier, too.

In conclusion, while there are certainly other areas where individuals might find fault with the new plans, I think that most farmers would support the attempts of the three tax reform proposals to achieve greater equity in taxation and to simplify the tax system.

[The prepared statement of Mr. Moore follows:]

STATEMENT BY

James E. Moore,
Partner, MOORE, RASMUSSEN, SABERS & KADING, Attorneys At Law,
131 North Main Avenue
Sioux Falls, SD 57102

Before subcommittee on income tax proposals, United States Senate Small Business Committee.

February 13, 1985

I have reviewed the comparison by Coopers & Lybrand of the 1985 tax reform proposals embodied in the Treasury Department, Bradley-Gephardt and Kemp-Kasten plans, together with other materials available to me. I would like to comment on certain aspects of those proposals with emphasis on their potential effect on farmers.

But first let me point out that there is a genuine concern among a significant number of taxpayers that the so-called "flat tax" proposals will eliminate all deductions from income --- not just the so-called non-business deductions --- resulting in a tax on gross receipts. This is considered by an already beleaguered segment of our citizens to be a final blow. Information should be disseminated to clarify this point and to re-assure these persons that none of the proposals would deprive them of their continued right to deduct the ordinary and necessary expenses of producing income under Section 212 of the Code.

A number of the proposed changes in our tax laws would have a significant effect on farmers. I would like to comment on just a few.

CAPITAL GAINS

First, I note that all three proposals eliminate the present 60 percent exclusion for capital gains. Capital gains affect farmers primarily in two areas:

(1) upon sale of their farmland, and

(2) upon sale of their draft, dairy and breeding livestock.

Capital gains are encountered most frequently on the sale of livestock, but exposure is most dramatic when the farmer sells land which he has held for many years at a greatly appreciated value (if measured in dollars). In fact, most of this appreciation results from inflation --- the depreciation of our currency. Since the land usually represents a large portion of the farmer's assets, the income tax arising from sale of the land can be very substantial, even with the current capital gain provisions. In some instances this tax may discourage passing the land on by any means other then by inheritance, where a new basis is obtained.

The alternative minimum tax may deliver a double whammy here, catching an unwary seller by surprise and imposing an additional tax burden on this inflation generated income. The alternative minimum tax was intended to tax the very wealthy who it was felt paid too little tax, but in my experience it has all too frequently settled on the once-in-a-lifetime transaction where the farmer or small businessman retires and sells out.

It is to the credit of both the Treasury and Kemp-Kasten proposals that they would index basis so that only real gains, and not gains arising from inflation, would be taxed. This might well create a preferable result for farmers, even though the real gains would be taxed at ordinary rates.

One further point relating to capital gains: while it may be argued that higher taxes on capital gains may discourage risk taking, I don't believe this factor would have much effect on farmers. Their motivations are otherwise, and of course the risks of drought, flood, pestilence, wind and hail, among others, are much more real to them.

INVESTMENT CREDIT

Since farming is a capital intensive business, the investment credit, which has been available since 1962, has been of great help in permitting the retention of capital for acquisition of necessary equipment and facilities. All three proposals would repeal the investment credit.

Repeal of the investment credit would have a definite adverse effect on the farm community. Particularly at the present time when farmers are plagued by low prices, high interest rates and short capital, this provision of existing law is of continuing importance to them.

Recognizing, nevertheless, that repeal may occur, it is hoped that existing carryovers of unused credits may continue to be usable over a reasonable period of years.

BUSINESS VEHICLES

So much has been said recently about the proposed new record-keeping rules for cars and pickups that I won't belabor the point other than to say that I have rarely seen so much feeling and emotion over any tax issue. The feeling is strongly and almost universally held that the log-keeping proposal was far too burdensome.

CONCLUSION

While there are certainly other areas where individuals might find fault with the new plans, I think that most farmers would support the attempts of the three tax reform proposals to achieve greater equity in taxation and to simplify the tax system.

Senator **Pressler**. Thank you very much, Jim.

How is your time running? Shall we hear from the other two witnesses?

Mr. **Moore**. Yes, certainly.

Senator **Pressler**. OK, great.

I will call on Burton next, if you would like to give your statement. Burton Ode is a dairy farmer from Brandon. We are glad to see you.

Is it thoroughbred Holsteins or grade Holsteins or both?

Mr. **Ode**. I have a grade Holstein herd and also beef and hogs.

STATEMENT OF BURTON P. ODE, FARMER, BRANDON, SD

Mr. **Ode**. I never made any mention of capital gains tax in my testimony, and I find this rather interesting. I have long felt that capital gains and accelerated depreciation rather was kind of a quick fix to reduce income taxes. My newest piece of machinery, large piece of machinery is over 10 years old. So I have always taken a long depreciation schedule.

But to get to my written testimony, I want to thank Senator Pressler for the invitation to make some remarks on the proposals to reform the Federal tax laws of our great country.

I have been a farmer all my life on the farm my grandfather bought in 1887. Having been born in 1923, the boom and the bust of the late twenties and the thirties are still fresh in my mind. We knew it would happen again. It was just a question of when. Fifty years ago it was economics and weather that wrecked havoc with the agricultural economy. The farm situation today is mostly caused by economics.

There are several causes for this. I think our tax laws are responsible for the 1970 boom and the 1980 bust that has hit the farmers in our area as much as anything else.

In writing tax laws we must be careful that investors outside of agriculture are not given encouragement through liberal investment credits and accelerated depreciation. Any losses through their farming businesses could be shared by their other investments and their ability to pay more for land and the production from it can be unfair competition for the family farmer whose entire livelihood comes from the farm.

Liberal investment credits and accelerated depreciation have encouraged many farmers to buy more and bigger machines than they really needed and now they are suffering the consequences. A longer depreciation schedule would even out investments and keep business on a more level basis.

Income averaging is beneficial to farmers because of the tremendous fluctuation in their income. The rise and fall in income is partially due to the prices of our products or the time of marketing from one year to the next.

The greatest problem though is the weather. Everybody talks about it, but nobody can do anything about it. One year may be a bumper crop and the next year a complete loss in the form of dryness and hail. Income averaging will even out the good years and the bad years.

The raise in personal exemptions to $2,000 is long overdue and I hope that this is put into effect. Thousands of dollars of fringe benefits of employees are not taxed at all. These should be fully taxed. Under present law farmers and small businessmen must first earn the money and then pay taxes on it before they can have the same benefits. This inequity in our tax law needs immediate attention.

Because of the large investment in property that a farmer must have to generate a moderate income, property taxes are a large expense item. A farmer's support of local government and schools through his tax payments is several times that of a person in town. We must be able to deduct as an expense item the taxes on income generating property.

The interest deductions on personal home loans is an area that I felt should be given more consideration. There should be a limit placed on the amount of the principal of the home mortgage that interest payments would qualify as an expense. This interest deduction should be only for moderately priced homes and certainly not on second homes.

To summarize, I generally favor the Treasury tax plan over the Bradley-Gephardt or the Kemp-Kasten plans. Overall there was not much difference in the amount of taxes paid in the lower brackets of either plan.

The Treasury plan for personal exemption of $2,000, the income interest, expense and indexing and income averaging were good. Any new tax plan adopted should include the following:

Interest expense on personal homes should be limited to one moderately priced home;

Taxes from income earning property must be a deductible item;

Depreciation set up on longer schedules; and

Fringe benefits must be taxed.

My remarks have been mostly limited to those areas that affect my farming business.

Thank you for the opportunity to speak before you.

Senator **Pressler**. Thank you.

[The prepared statement of Mr. Ode follows:]

Burton P. Ode
Farmer
RR 1 Box 3
Brandon, SD 57005
Field Hearing by Senator Larry Pressler
Senate Small Business Committee
February 13, 1985
Sioux Falls, SD

I want to thank Senator Pressler for the invitation to make some remarks on the proposals to reform the Federal Tax Law of our great country.

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There are several causes for this. I think our tax laws are as responsible for the 1970 boom and the 1980 bust that has hit farmers in our area as anything else.

In writing tax laws we must be careful that investors outside of agriculture are not given encouragement throuugh liberal investment credit and accelerated depreciation. Any losses through their farming business could be shared by their other investments but their ability to pay more for land and their production from it can be unfair competition for the family farmer whose entire livelyhood comes from the farm. Liberal investment credits and accelerated depreciation have encouraged many farmers to buy more and bigger machines than they really needed and now they are suffering the consequences. A longer depreciation schedule would even out investments and keep business on a more level basis.

Income averageing is beneficial to farmers because of the tremendous fluctuation in their income. This rise and fall in income is partly due to prices of our products or the time of marketing from one year to the next. The greatest problem is weather. Everybody talks about it but nobody can do anything about it. One year may be a bumper crop and the next year complete loss from dryness or hail. Income averageing will even out the good years and the bad years.

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The Treasury Plan for personal exemption of $2000.00, income interest and expense indexing and income averageing was good. Any new tax plan adopted should include the following:

-Interest expense on personal home should be limited to one moderately priced home

-Taxes from income earning property must be a deductable item

-Depreciation set up on longer schedules only

-Fringe benefits must be taxed.

My remarks have been mostly limited to those areas that affect my farming business.

Thank you for the opportunity to speak before you.

Senator PRESSLER. Eldon Johnson, who has thoroughbred Charolais I believe; is that right? Do I have the right breed?

Mr. JOHNSON. Thank you for the advertising.

Senator PRESSLER. OK. [Laughter.]

STATEMENT OF ELDON R. JOHNSON, OWNER, LILAC CREST CHAROLAIS FARM, HARTFORD, SD

Mr. JOHNSON. Senator and other members of the committee, thank you for inviting me to participate as an official witness at this meeting.

My testimony will be based on the tax reform as it would relate to agriculture because of my business as a farmer, but I am sure it will also be relevant to any small businesses in our State or any State for that matter, because of the fact that agriculture affects such a big percentage of small businesses in our rural area.

I don't have to tell you about the farm crisis that grips rural America at the present time. You are well aware of that. However, there are things about agriculture and farming and small business as well that are unique as compared to most other businesses. For instance, much of our machinery is used on a seasonal basis, combines, corn and bean planters and hay equipment, just to mention a few. These are expensive pieces of equipment. Yet, they are needed by almost every farmer because of the time element involved in each operation. All farmers are doing the same work on the farm at the same time.

Compare this to a manufacturing plant that produces, let's say, automobiles where the plant is in operation all year long. On depreciation of our equipment, I believe that farmers should have a choice of depreciation deductions based on their business needs and yet within a normal lifetime of that certain piece of equipment. The same applies to livestock purchased or raised for breeding purposes or used in their business such as dairying or swine or beef.

Along these same lines, I definitely believe that we need to retain the 60 percent exclusion of long-term capital gains. As an example, because I raise purebred cattle, I will be more apt to bring in a new herd sire into my herd, and for a substantial price knowing that I can depreciate him as I feel his worthwhile life will be to my business and also knowing that I can claim him as a capital gain when I sell him in the market. It is an incentive to increase the potential value of my herd and to sustain economic growth of the livestock industry, just to mention one of the facets of agriculture.

In regard to income averaging, I believe it is a very good provision and should be retained. Rarely does a farmer have 2 years that are of the same income level. I have used income averaging through the years and it has definitely been a worthwhile provision.

If the top rate of taxation is to be lowered as is proposed, I believe that the brackets of taxation should be kept at more brackets than within the Treasury plan or Bradley-Gephardt plan, but probably not as many as we have now under the present law.

I like the idea of having to be able to put into an IRA an equal amount for my spouse. Surely on a farm a wife is an integral part of our operation and should be treated as an equal partner in our operation. With concerns of the financial condition of the Social Security Program, this seems to be a very important provision.

Definitely I think the law should be easy to read and in understandable language so one can determine how they apply. Most everybody has the need for a basic deduction, and then simplify the reports for those who have extra deductions such as medical and so forth.

I believe the laws should be so that no one is allowed to use agriculture as a loss or deduction if they are not full-time farming or at least a big percentage of their income is from farming. Too many wealthy people are using agriculture as a tax writeoff. Recently I heard an investment specialist tell his clients to invest in agriculture if they needed a tax writeoff. Is it any wonder that we in agriculture are in a crisis?

The United States is great because of the entrepreneur from the very beginning of our history. Let's be sure our tax system rewards him by giving him the tax breaks he needs. His investment today is higher than it has ever been and the profit is less. The same is true of the farmer. He takes great risks to keep food at the bargain it is. Thank you.

[The prepared statement of Mr. Johnson follows:]

Eldon R. Johnson
Owner - Lilac Crest Charolais Farm
RFD #2, Box 141
Hartford, SD 57033
PH: (605) 598-3488

Subcommittee of the Senate Small Business Committee on Tax Reform Proposals

February 13, 1985 at Sioux Falls, SD

Senator Pressler, other committee members:

Thank you for the invitation to participate as an official witness at this hearing. My testimony will be based on the tax reform as it would relate to agriculture because of my business as a farmer, but I am sure it will also be relevant to any small business in our state or any state for that matter, because of the fact that agriculture affects such a big percentage of small businesses in our rural areas.

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Senator PRESSLER. Well, I thank the witnesses for this excellent testimony, and I think it sheds light from an agricultural point of view and small business point of view that we don't hear too often.

I might ask all of you about the fact that much of agricultural machinery is used on a seasonal basis. I think that is a good comment that Eldon made in terms of depreciation. Do you feel there should be some special consideration of this compared to a company that is able to use machinery year around or what are you suggesting here?

Mr. JOHNSON. Well, yes, I do, and then I think probably over the years some farmers would prefer to take a shorter life or a longer life, and I think there should be some options in there. We have had that in the past and I really believe that that is a good provision. A tractor, for instance, if we have two or three tractors, some tractors are used more on a seasonal basis and some are used year round, and I think probably a depreciation schedule that fits those different categories is necessary with an option in their life according to their business needs. And, yet, within a normal life it is, you know, equitable.

Mr. MOORE. I would agree with that, Larry, that there should be more options for the farmers to set their machinery up as they feel they will use it under the new system, the ACRS, accelerated cost recovery system. They have an option of 5 years, 12 years, or 25 years, and that probably doesn't give enough flexibility for the normal farmer. Five years is pretty short, and I think I would agree with the comments Mr. Ode made earlier about that. Twelve years may be too long on many things, and 25 years of course to set up an ordinary piece of machinery is much too long.

Prior to ACRS we had lots of options in setting up machinery. I think people did a better job for themselves than the law does for them now, and I am not sure that these short terms for depreciation are necessary for farmers.

Senator PRESSLER. All of the tax plans that have been proposed this year, as I understand them, have eliminated the preferential treatment of capital gains, and I guess some of you have commented on that. How would that affect farmers and businesses?

Mr. ODE. Well, to do away with the capital gains would certainly affect us that have breeding stock and have livestock as a large part of our operation. I don't sell anything off my farm but meat and milk. I consequently have a breeding herd and it amounts to quite an item for me to be able to deduct my old worn out cows and sows at 60 percent and I used a capital gains on those items.

Mr. MOORE. If I may comment on that. My experience would indicate that when animals are purchased, if you could take away inflation, that capital gains would not be a problem, and I don't know if Mr. Ode will agree with that. But when he raises an animal that has a zero basis, and if he raises that animal and uses it for breeding purposes, then whatever it sells for finally is all capital gains.

Generally speaking, if you purchase a bull, I think when you sell that bull later you take a loss on it, would you not? And so your capital gains provisions are meaningless there. I think probably in most cases that would be true if you purchased a breeding cow, for example, that you wouldn't have much gain at the time of sale, that is, over the original cost and not factoring in the depreciation you might take in the meantime.

But it is of some importance, and it is less important if you take out the inflation factor as some of the bills have tried to do. I think that would be especially important on the sale of the farm itself. I don't think there would be much gain if you take out the inflation factor.

Mr. **Johnson**. I will agree 100 percent with Mr. Moore.

Senator **Pressler**. The various reform proposals all lengthen the so-called useful life of depreciable property; which you have just covered in part. What effect would that have on farm taxes?

Mr. **Moore**. I don't think most farmers would have any objection to that.

Mr. **Johnson**. No; I don't think so. I think a good, normal life, every piece of machinery has, you might say, a little different life span.

Mr. **Ode**. I really feel accelerated depreciation and investment credits have made, as I mentioned, a boom and a bust effect, especially even farm machinery dealers. They were going great in the 1970's and farmers were making money and in order to reduce their income tax they would buy another larger piece of machinery and write it off as fast as they could. The machinery dealers were real happy and the farmers were real happy and suddenly the income wasn't there to go back and do that again. The machinery was written off and there wasn't any possibility of going back and picking up any depreciation.

Like one man mentioned at a meeting I was at yesterday. He said back in the days when we bought new machinery. So it just means he couldn't buy any more. Machinery dealers are really hurting because the farmers just can't buy it any more. But I do think fast writeoffs did create a boom and a bust effect in the machinery business.

Mr. **Moore**. If I may make one more comment with regard to depreciation. You asked earlier if farmers had a special problem. I think they do because they are seasonal users, as was mentioned earlier.

Take, for example, the farmer who buys a combine in October, or a corn picker would be more appropriate in October, and combines his corn crop. He has used that machine for an entire year. Now under ACRS we have the 6-month convention and whether you bought that machine on the 1st of January or the 31st of December you get one-half year's depreciation on that machine.

Under the old law if you bought a machine in October you got 3-month's depreciation, and that was never fair to farmers because they had used that machine a full year so far as they were concerned. And there should be some provisions in the law which recognize this with respect to farmers, and there never have been before.

Senator **Pressler**. OK. Now is there a bias, in your view, in favor of large rather than smaller family farms in our tax law?

Mr. **Ode**. I never considered that in reviewing for this. I am not enough of an expert to go into the difference, but the small farms generally don't have to pay much tax because they happen to generate enough income. It depends on how small you mean small. I think our average farm in this county is about 430 acres. There are some farms that are probably quarters, but then the person has another job off the farm to supplement its income.

I think right now less than half the farmers earn their entire income from the farming and the other half earn more than half their income in off farm jobs.

Senator **Pressler**. There is a proposal, which I support, that calls for eliminating use of nonfarm loss writeoffs in that sense. How would that affect someone who worked parttime. I suppose if they wrote off farm losses or farm depreciation or whatever, it would put them in a very difficult position.

Mr. **Ode**. It would take me a little time to think about that and analyze it, but I think it would affect them.

Senator **Pressler**. What effect would that proposal have on getting capital into agriculture? Indeed, I support the concept, and I think both witnesses said it here, to try to find ways that nonfarm investors can't write off losses so easily. On the other hand, there are dairymen whose only source of money is the nonagricultural investor. There are farmers and ranchers who can't get a loan but who can find a partner who will provide the capital, and that is the same as a small business owner. When that is done it is often very much resented, but it is the way some farmers and ranchers get capital, and how do we resolve that dilemma?

Mr. **Moore**. I think it is a very difficult question because there are a lot of farmers who have second jobs and they are legitimate farmers and they are trying to keep their farm operation going to get them over the hump and get their bills paid off or whatever. There are an awful lot of people who have worked for many, many years at Morrels who are legitimate farmers, for example.

I don't know how you would draft legislation that would screen out the people you don't want in there and yet cover the ones that are OK. There is where you run into all kinds of problems, and I sympathize with what Eldon said earlier, but it is a big problem and there are a lot of legitimate people out there who need that second job, and what kind of provisions do you put in to separate the two? I don't have any solution.

Senator **Pressler**. Another difficult question in this tax policy regards spousal IRA's, the individual retirement accounts. Senator Dole feels strongly that we can't afford to allow a spousal IRA.

Of course, in many cases in farms or small business the wife may not be working outside the home. She is probably not salaried, however, she is likely working a great deal in the business or on the farm and we do not allow a spousal IRA.

The other side of this coin when I am talking about taxes is that we do have an enormous deficit, and Senator Dole, who is the majority leader of the Senate is determined to close some of the loopholes.

But in any event, I think Eldon or Burton mentioned that it would be a very good thing to have a spousal IRA for farm wives. But how would we resolve that nationwide? Would we allow a spousal IRA only if a wife worked in a business or would you just allow spousal IRA's across the board? In a case where the wife is not working or is not involved in the business it becomes a great loss of revenue and how would you resolve that?

Mr. **Moore**. Let me suggest, Larry, that that would create a much lesser loss of revenues than, for example, increasing the exemption to $2,000 across the board because we are talking about a lot less $2,000 if we grant the spousal IRA than we are if we give everybody in the United States an extra $2,000 exemption.

Senator **Pressler**. Also, the spousal IRA encourages savings. That is another thing that is positive about it in terms of our fiscal system, something that we don't do as much of as, say, the Japanese, but I appreciated that testimony very much.

Let me just touch on some other points here in the testimony. The interest expense on a personal home should be limited to one moderately priced home. That certainly sounds reasonable to me. There is a proposal by the Administration to limit the deduction on vacation homes, which is something that sounds eminently reasonable. I think it was you, Burton, that mentioned that.

Mr. **Ode**. In two of the proposals the interest deduction is allowable even on second homes. The Treasury plan limited it to one home. It didn't say whether it would be a $100,000 home or a $1 million home, and I really think there should be a limit of some kind. A person that builds a $1 million home I felt should not be able to deduct the interest.

Senator **Pressler**. Well, we have the phenomena in Washington, DC of a great many people who live in New York or California and own an apartment or a house in Washington which is, I guess, used for ordinary business expenses. That could be dealt with in regulations, I think, in terms of definition of what is an ordinary and reasonable business expense.

Mr. **Ode**. As a business home I suppose probably some type of exemption could be made.

Senator **Pressler**. Well, it is being made, but I don't know if they should be quite so liberal with it. I have been troubled by some of the situations I have observed.

Now what about State taxes being deductible? Again, it is a proposal that Senator Dole has. He feels strongly that our States could be doing much more in this whole budgetary thing, that nearly 40 percent of many of our States' budgets are made up of Federal funds and yet State taxes are normally deductible. Should they be? Of course you pay taxes to one level of government and you hate to pay taxes again to another level of the Government.

Mr. **Moore**. Are we talking here about taxes which are deductible as an expense of doing business or taxes which are deductible to everyone, for example, on their personal residence?

Senator **Pressler**. Well, both. Let's talk about the two categories.

Mr. **Moore**. Well, certainly taxes which are a necessary expense of doing business should be deductible, and I don't think there is any proposal to do away with those. This is one of the things I alluded to earlier when I said there is some confusion out here in the hinterlands about these deductions.

Some people are concerned, for example, that if there is a flat tax and we are going to eliminate taxes and interest that it is going to eliminate all taxes and interest even including the expenses of doing business.

I don't think you can take away the expenses of doing business as a legitimate deduction for everyone. On the others, for example, why are taxes deductible on a home and not insurance? There is no logical reason I can think of why that should be true, except it has always been that way. But it is just a deduction that is allowed us by the tax law which we have come to take for granted, and I suppose there is no magic in it. And if nobody got it, I suppose it would be fair to everyone.

Senator **Pressler**. Yes, that is right. All three proposals the Treasury Department, the Bradley-Gephardt tax reform, and Kemp-Kasten, all would repeal the State and local tax deduction for real property taxes, personal property taxes, income taxes and sales taxes.

Of course this is mainly on business and agricultural taxation and it leads us to the area of personal income taxes. Jim, you talk to a lot of taxpayers every day. Is there a great level of frustration with our Tax Code?

Mr. **Moore**. I think there is, and of course I have a lot myself, and let me give you couple of examples.

Last year the law was amended which limits the amount of the contribution to the self-employed retirement plan. Before this time the amount was limited to 15 percent of earned income. It was raised this last year to 25 percent.

The only thing is that when they raised it they said that you must reduce the amount of the earned income by the amount of the deduction. Now if you think about that for a minute you realize that it is a very difficult computation. As a matter of fact, it is almost impossible to make. You have to have a formula to make it. Actually it results in about a 20-percent deduction, but why couldn't they have just said a 20-percent deduction instead of making it 25 and then turn around and reduce it with an impossible formula there, something that most people can't really apply. They can't compute it without a formula.

Another example of where laws are unnecessarily complex, in my view, is we were talking about capital gains on the sale of livestock a while ago. There is a section of the code called 1231, and it says basically that although livestock are not really capital assets, if gains from the sale of livestock exceed the losses from the sale of livestock, the net gains will be treated as capital gains. Now if the gains do not exceed the losses, the net losses will be ordinary losses.

Effective in 1985 there is a new provision in there that says that even though you have net gains from the sale of livestock or other 1231 assets, they will not be treated as capital gains until you have wiped out all the losses you have deducted over the last 5 years. So now every farmer is going to have to keep a running account of 5 years of gains and losses from the sale of section 1231 assets in order to compute his current income tax, and to me that is just ridiculous.

That is just impossible to understand for anybody except somebody who has really studied it and even then it is difficult. We have so many carryovers and carrybacks in the law now that it is just too complex. There is no purpose in it, and I for one would welcome a great amount of simplification in the tax law.

Senator **Pressler**. The problem I have with the three proposals is that they claim to be forms of a flat rate tax, but yet they are not because they start the whole game all over again. I think I could support a flat rate tax that was truly flat—that didn't have any deductions or exemptions of the type we are talking about here. But once you open the flood gates, you are right back where you started, and that is my problem with all three of these.

Even with the problems that these three proposals have, would each of you favor the adoption of a flat rate tax, or how do you feel about that?

Mr. ODE. I have heard of the Kemp flat rate tax rate myself at least for a couple of years, and what a simplified tax plan it would be. So when I received this invitation to testify today and reviewed the material for these three different tax plans, I was really disappointed in the Kemp-Kasten tax plan. It isn't as simply as it could be and I will still have to go to my tax man to have him compute my taxes.

I had hopes that I could save the money that I put out for tax help and I think a lot of people have felt that way, but I don't think that it is going to be possible.

Senator PRESSLER. Well, I am glad to hear you say that because I think that the untold secret of these tax reform plans is that they are very complicated. They are not as simple as each legislator advocating them, whether it is Bill Bradley or Jack Kemp, would have us believe. Each of these individuals has their own interests, that is the interest of their constituency, to protect, and we find ourselves back at the same old place as we were before we started.

Let me ask the two farmers on the panel. Do you do your own taxes or do you have professional help?

Mr. JOHNSON. I hire a tax person.

Mr. ODE. And I hire a tax person

Senator PRESSLER. Well, so do I, but, all of my taxes are pretty simple. [Laughter.]

Mr. ODE. Your depreciation schedules and other things require so much time that I just couldn't do it myself. I have my farm work to take care of, and then I would probably end up doing it wrong.

Senator PRESSLER. I think this illustrates a great problem that we have. If you have to have someone assist you, I am sure that most people do. We have reached the stage where our citizens really can't have confidence in a system of taxation that they can't understand and in which they imagine that everybody else has got all kinds of deductions and exemptions. They may be right or they may be wrong, but they have lost confidence in the basic program, in my view, and that is why I think it is so important that we have some basic tax reform.

Mr. JOHNSON. I think we have got a lot of equities in our present program, taxation, but I think if they change it they have to be very careful so they don't muddle it up any more. I am sure there are some equities we can live with, but I think at the same time, like you say, in order to make it simple, we have to be careful that we don't make it more complicated.

Senator PRESSLER. That is right. We have not even touched upon the issues of State and local bonds being tax exempt and what impact that has on employment, the lease-back thing, which I think we probably should repeal and, indeed, I would support and vote for repealing it. There is also the whole issue of agricultural cooperatives and their tax status and the REA's and when they pay dividends and when they don't and what impact all of this would have on them which really hasn't been defined in any of these plans.

I am just afraid that by the time any of these plans, especially the Bradley-Gephardt, was adopted agriculture would be in very bad shape.

Well, I could go on here. As people in the audience can tell, this subject is very complex. In Washington when we have these hearings and work on each of these items individually, it requires an immense amount of effort and understanding and you have contributed to that and I thank you very much, and I thank you for being here.

Mr. **Johnson**. Thank you.

Mr. **Moore**. Thank you, Larry.

Mr. **Ode**. Thank you. [Applause.]

Senator **Pressler**. Now I am going to call forward the next panel which consists of Roy Nyberg from Ace Hardware, Lyle Bjorklund from Volga, who is head of Bjorklund Foods, Inc., Jack Danz from Lakeside Dairy and Tom Batcheller, president of Zip Feed Mills.

While they are getting in place let me say to the people that came late that the purpose of this hearing is to look into tax reform from an agricultural and small business point of view and to get individual input.

In Huron this afternoon we are going to look more at the individual income tax problems, but this hearing is focused mostly on agriculture and small business. It is a technical subject, but it is one that is of great importance. There have been three reform plans that are much touted in the media, all of which supposedly are flat rate taxes or simplified taxes.

But as we have seen from passing out this tax rate sheet, the so-called reforms get very complicated and have exemptions and deductions and so forth. So we might be getting back into the same old boat. But one thing is certain, the American people are demanding tax simplification.

Panel No. 2, I thank you very much for being here. I see Roy Nyberg, a good friend for a long time and one of our State's leading businessmen.

Roy, why don't you lead off.

STATEMENT OF ROY D. NYBERG, PRESIDENT, NYBERG'S ACE HARDWARE, INC., MEMBER, BOARD OF GOVERNORS, NATIONAL RETAIL HARDWARE ASSOCIATION, SIOUX FALLS, SD

Mr. **Nyberg**. Thank you, Larry.

Please excuse me. I am not going to show some of the enthusiasm that I can generally and usually do put out, but this is the second day out of the house since January 14 and I think I got pneumonia along with that.

Thank you, Senator.

I appreciate this opportunity to testify before the Senate Committee on Small Business concerning the issues of tax reform.

I am Roy D. Nyberg, president of Ace Hardware, Sioux Falls. I am also privileged to serve on the Board of Governors of the National Retail Hardware Association, a 20,000 member trade association representing hardware stores and home centers.

I represent hardware retailers in all of North and South Dakota, Minnesota, and Iowa. I am a past president of the Board of the Minnesota-Dakotas Hardware Association and I would like to read a statement and then answer any questions you might have.

I would like to commend Congress and the administration for pursuing deficit reduction through spending restraint before addressing in detail the task of major tax reform.

Something as critical as tax reform should not be allowed to become a bargaining chip for another legislative initiative and I applaud Congress for dealing with these issues on separate tracks.

As you well know, the need to dramatically reduce spending and provide for a more fair and equitable tax system are both essential in laying the foundation for sustained economic growth and greater tax compliance.

I hope that Congress will take broadbrush approach to the spending freeze proposals now before it and not allow the "sacred cow" syndrome to prevail. If Congress and the administration are serious about producing a significant spending and reduction package, there should be no exceptions to the freeze.

Some of us, however, believe that the freeze concept should not be restricted to Federal spending programs. Under existing law, Social Security or payroll tax rates have risen or will have risen 9 out of 13 years between 1978 and 1990. By 1990 employer/employee will each pay a Social Security tax rate of 7.65 percent of wages, together paying an FICA tax rate exceeding 15 percent of a worker's wage.

I would ask you, Senator, to consider a freeze on further Social Security tax hikes before escalating payroll taxes undermine the ability of small businesses to expand and grow.

At the end of my remarks, I am going to have some figures that are not in this report that support a general statement of that nature.

I have long since acknowledged the responsibility of providing a modest pension for our older citizens, but we must recognize the limits of that fund or else preclude younger Americans from employment opportunities and reduced productivity in the process.

I personally started paying Social Security taxes in 1938 and won't be 65 for another 7 years. Nyberg's Ace Hardware 1984 Social Security contribution on behalf of its employees was a whopping $20,871, 7 percent of the annual payroll.

It is not my intention today to endorse one of the many tax proposals before Congress. I am encouraged, however, by the common threads that run through the leading reform plans, specially lower individual and corporate tax rates, a broader tax base and elimination and reduction of numerous tax shelters, deductions and credits, many of which distort investment and hinder economic growth.

The three major proposals, Bradley-Gephardt, Kemp-Kasten and the Treasury Department's, all reflect a position that holds the general interest in higher regard than special interest.

While paring back and eliminating many of the tax breaks that benefit certain sectors of our society will take political courage, Members of Congress should be confronted by the fact the American people hunger for a tax system characterized by simplicity and equity.

The current system leaves an overwhelming majority of Americans, 77 to 19 percent, feeling that their own taxes are unreasonable according to a recent Lou Harris poll. This discontent exists even though President Reagan's 1981 tax bill reduced individual rates by more than 20 percent over a 3-year period.

I believe the reason why there is so much dissatisfaction with our current income tax can be found in the results of another question put forth by Mr. Harris. When I asked whether "most higher income people get out of paying much of their taxes by having tax accountants and lawyers who know how to use the polls of the tax law for tax shelters and other devices," 80 percent responded yes, while only 70 percent said no.

As a retailer I agonize over the high tax rates that retailers pay. While the figures vary among different industries, the retailing community ranks at the top of the list when it comes to paying taxes. In recent years the uncontrollable expenses, such as Social Security taxes, unemployment insurance taxes, workmen's compensation insurance rates and the real estate taxes all have increased. Again, this is what I am going to speak to later to support a general statement.

When you consider additional rising expenses for hospitalization insurance, interests, telephone and energy costs, these increased pressures have not permitted small business to increase profits for future growth. It is difficult to sustain a satisfactory bottom line.

Here is what I would like to just inject here if I might. The hardware industry, if you will appreciate that 2 to 2½ cents or 2 to 2½ percent out of every dollar that we take in at the cash register is left to us for profit. After we pay all of our bills and after we pay all of our taxes and all of our expenses, we hopefully can keep on an average between 2 to 2½ cents out of every dollar that you people spend with us.

Now that means if I am doing a $2 million volume that I am hoping to realize $50,000 of tax which is going to be taxable. I think that is the key that I want to bring out. But along with that, and keep in mind that in 1984 these are the dollars that I spent in taxes not including income tax, as I reported Social Security, $20,871 of my income from sales went to Social Security taxes; unemployment tax, $2,440; workmen's comp, $4,214; real estate, $19,500; a total of $47,000 before I even begin to pay income tax.

Now if I can apply four other items that are not taxes, but they are uncontrollables that I have no control over. Hospitalization insurance, we have $6,000 of hospitalization insurance, and we have a very limited participation. Our telephone bill went up 17 percent. NSP just last month in December, if you remember a year ago in December how cold and miserable it was around here, and this year we had a moderate December, and my bill was $400 more than last year, and that is because of the energy clause. I suppose I am paying for a nuclear plant that they never got off the ground over in Minnesota. And interest again would be another one. The Federal Reserve Board is comprised of member bankers, they control their own interests.

So when you talk about all these uncontrollables and the taxes, it is very difficult for small business to sustain a bottom line. That is where I would favor at least portion of the Kemp-Kasten. And now I see, Stewart, you have modified this since the report was out. But originally it was 15 percent up to $50,000.

Now if you can envision that that would be the approach I would like to see. We all have to pay taxes. So I don't mind paying 15 percent on the $50,000. So that means I would be paying $7,500 on that $50,000 profit, which would leave me $42,500 for dividend distribution or for the retention of capital.

So basically those are the figures that I wanted to insert to support the fact that we are paying a lot of taxes and it does erode from our bottom line.

To summarize my position, it is imperative that the Federal Government must first slash Federal spending. A few years ago I made a comment to Congressman Daschle, and this is a quote "It is an extremist remark, but the bureaucracy must reduce its size by 25 percent or reduce its salary by 25 percent. They have the choice." President Reagan recently said "A 20 percent cut in the administrative section of Social Security is in order."

Many Americans agree with Budget Director Stockman's remark in regard to military pensions, but it shouldn't end there. Many Government salaries and pensions exceed what the private sector pays on the average. One example, compare a postman's salary and a pension to a teacher.

If a sincere effort to cut Government expenses occurs, the American people will not rebel against paying taxes, especially if many of the proposals are adopted to eliminate loopholes, tax loopholes so major corporations and professional earners pay their share of the taxes.

So when I witness a broad cross-section of the American society call for a system with individuals and businesses with similar incomes to pay similar taxes, I am enthusiastic and optimistic that a more fair and equitable income tax system is within reach.

That concludes my statement and I will be happy to take your questions. Thank you.

[The prepared statement of Mr. Nyberg follows:]

STATEMENT

BY

ROY D. NYBERG

PRESIDENT
NYBERG'S ACE HARDWARE, INC.

MEMBER
BOARD OF GOVERNORS
NATIONAL RETAIL HARDWARE ASSOCIATION

Before
Senate Small Business Committee
to Examine Impact of Tax Simplification
on Small Business

February 13, 1985
Sioux Falls, South Dakota

Thank you, Senator. I appreciate this opportunity to testify before the Senate Committee on Small Business concerning the issue of tax reform. I am Roy D. Nyberg, President of Ace Hardware of Sioux Falls. I am also privileged to serve on the Board of Governors of the National Retail Hardware Association, the 20,000 member trade association representing hardware stores and home centers. I represent hardware retailers in all of North and South Dakota, Minnesota and Iowa. I am a past president of the Board of the Minnesota-Dakotas Hardware Association. I would like to read a statement and then answer any questions you might have.

I would like to commend Congress and the Administration for pursuing deficit reduction through spending restraint, before addressing in detail the task of major tax reform. Something as critical as tax reform should not be allowed to become a bargaining chip for another legislative initiative, and I applaud Congress for dealing with these issues on separate tracks.

As you well know, the need to dramatically reduce spending and provide for a more fair and equitable tax system are both essential in laying the foundation for sustained economic growth and greater tax compliance.

I hope that Congress will take a broadbrush approach to the spending freeze proposals now before it and not allow the "sacred cow" syndrome to prevail. If Congress and the Administration are serious about producing a significant spending reduction package, there should be no exceptions to the freeze.

Some of us, however, believe that the freeze concept should not be restricted to federal spending programs. Under existing law, Social Security or payroll tax rates have risen or will have risen nine out of thirteen years between 1978 and 1990. By 1990, employer and employee will each pay a Social Security tax rate of 7.65 percent of wages, together paying a FICA tax rate exceeding 15 percent of a worker's wages. I would ask you, Senator, to consider a freeze on further Social Security tax hikes before escalating payroll taxes undermine the ablity of small businesses to expand and grow. I have long since acknowledged the responsibility of providing a modest pension for our older citizens, but we must recognize the limits of that fund or else preclude younger Americans from employment opportunities and reduce productivity in the process. I personally started paying Social Security taxes in 1938 and won't be sixty-five for another seven years. Nyberg's Ace Hardware's 1984 Social Security contribution on behalf of its employees was a whopping $20,871, 7 percent of annual payroll.

It is not my intention today to endorse one of the many tax proposals before Congress. I am encouraged, however, by the common threads that run through the leading reform plans. Specifically, lower individual and corporate tax rates, a broader tax base, and elimination and reduction of numerous tax shelters, deductions and credits, many of which distort investment and hinder economic growth. The three major proposals — Bradley-Gephardt, Kemp-Kasten and the Treasury Department's — all reflect a position that holds the "general interest" in higher regard than "special interest."

While paring back and eliminating many of the tax breaks that benefit certain sectors of our society will take political courage, members of Congress should be comforted by the fact the American people hunger for a tax system characterized by simplicity and equity. The current system leaves an overwhelming majority of Americans — 77 percent to 19 percent — feeling that their own taxes are "unreasonable," according to a recent Lou Harris poll. This discontent exists even though President Reagan's 1981 tax bill reduced individual rates by more than 20 percent over a three-year period.

I believe the reason why there is so much dissatisfaction with our current income tax system can be found in the results of another question put forth by Mr. Harris. When asked whether "most higher income people get out of paying much of their taxes by having tax accountants and lawyers who know how to use loopholes in the tax law for tax shelters and other devices," 80 percent responded yes, while only 7 percent said no.

As a retailer, I agonize over the high tax rates that retailers pay. While the figures vary among different industries, the retailing community ranks at the top of the list when it comes to paying taxes. In recent years, the uncontrollable expenses such as Social Security taxes, unemployment insurance taxes, workmen's compensation insurance rates, and real estate taxes all have increased. When you consider additional rising expenses for hospitalization insurance, interests, telephone and energy costs, these increased pressures have not permitted small business to increase profits for their future growth. It's difficult to sustain a satisfactory bottom line.

To summarize my position, it is imperative that the federal government must first slash federal spending. A few years ago, I made a comment to Congressman Daschle: "It's an extreme example, but the bureaucracy must reduce its size by 25 percent, or reduce its salaries by 25 percent. They have the choice." President Reagan recently said, "A twenty percent cut in the administrative section of Social Security is in order." Many Americans agree with Budget Director Stockman's remarks in regard to military pensions, but it shouldn't end there. Many government salaries and pensions exceed what the private sector pays on the average. One example, compare a postman's salary and pension to a teacher's. If a sincere effort to cut government expenses occurs, the American people will not rebel against paying more taxes, especially if many of the proposals are adopted to eliminate tax loopholes so major corporations and professional earners pay their share of taxes.

So, when I witness a broad cross section of American society call out for a system where individuals and businesses with similar incomes pay similar taxes, I am enthusiastic and optimistic that a more fair and equitable income tax system is within reach.

That concludes my statement. I will be happy to take your questions.

Senator **Pressler**. Roy, thank you. I think you expressed well many of the frustrations that a lot of our small businessmen feel.

Let me next call on Lyle Bjorklund from Volga, a good friend who is a true small businessman in a small town, and we appreciate very much your driving down this morning.

STATEMENT OF LYLE G. BJORKLUND, PRESIDENT, BJORKLUND FOODS, INC., VOLGA, SD

Mr. **Bjorklund**. As Larry mentioned, I am a small businessman. I am from a small town of about 1,100 population and I have operated a grocery store there known as Lyle's Foodland at Volga, SD. We have been in business for 15 years and built a new building 7 years ago.

I want to thank Larry for this opportunity of having us here.

It seems to me that most of us as Americans have been at sometime or are unhappy with the present taxation method of our country. It is really going to be hard to ever arrive at a policy where everyone is going to be satisfied.

It seems to me as I listen to most people around me that they hate to pay taxes. But I have always said it is a good day in my life when I have to pay taxes because that means I have made some money. That of course is getting harder and harder to do each year.

I definitely feel that there are too many so-called loopholes in our present taxation process. I have always felt that churches and church properties should be taxed. There are some groups who call themselves churches and religious organizations and buy lots of land or property and don't have to pay taxes because they call themselves churches. If all churches paid taxes, this would be eliminated.

If churches can raise enough funds to keep existing, I think they should be able to raise the money for taxes, too. However, I feel that donations given to churches and charitable organizations should be a taxable deduction. This is the only means of survival that they have, and if not a taxable deduction, the amounts given may be substantially less and they would not be able to operate and survive.

As a small businessman I definitely feel that the proposal on interest income and expense could be quite a deciding factor for someone like myself and the farmer.

As it gets harder and harder to make a profit each year, we seem to have to borrow money more often. I feel that lots of us probably pay more interest than have it as an income. To us this interest expense as a deduction could leave us with more money to operate our business and keep afloat in the following year.

Interest rates have become so high that it is a big factor and expense in any kind of business that one is in, including farming. Inflation in the last few years plays such a big part in business that I definitely feel that it should be taken into account in the taxation system of our country. If we can get a handle on inflation, we could solve many problems in businesses and farmers going broke and having to borrow more money each year to keep operating.

A few years ago our State proposed and enforced a 5-percent decrease at all State employment and any State funded functions and projects. Instead of having a deficit in our State treasury, we have a surplus. Possibly something like this could be done at the Federal level and thus help to slow down inflation and also help to reduce the Federal deficit.

The main criticism I seem to hear when people have to pay taxes is that the Government is spending too much money and some of it unwisely.

The Treasury plan calls for taxation of employee benefits. Proponents argue that the impact to employers would be minimal, but analysts think that rather than pay high taxes workers and farmers would forego health and pension coverage and eventually put a demand on Government programs having to be financed by tax revenue from business and possibly lead to a nationalized health system.

If workers find their take-home pay reduced by taxation of their benefits, more pressure will be put on employers for pay increases to offset higher tax payments. If the benefit costs would be taxable to the worker, they would also be subject to payroll taxes paid by the employer and thus costing the employer more also.

We could possibly have the equivalent of the British style national health service if we start taxing all these health insurance benefits, and something like that would give us a worse health delivery system at an infinitely greater cost, probably a 13- or 14-percent payroll tax that would be paid to the U.S. Day Care Corporation and they would have the say as to who gets the benefits and also setting the qualifications of being eligible for these benefits. Let's not destroy incentives for some worthwhile things in this country.

I definitely feel that some business deductions for travel, entertainment and so forth should be allowed whether it be a mainstreet businessman or a farmer. Some employees and employers misuse this when they are gone overnight. Possibly putting a limit on some of these items would be a benefit to an employer as some business expense accounts are very costly to an employer.

A certain percentage of all expenses could be used as another alternative. Some business expense cannot be controlled, but such as travel and entertainment are some that could be.

I like the idea of all three proposals on repealing the tax exemption for income from State and local government bonds for private use. I also feel IRA and all such investments should be taxed.

We have been given three proposals, Treasury Department, Bradley-Gephardt, and Kemp-Kasten, to review. I feel there are good and bad in each one. Taking parts of each and putting them into one proposal would possibly be the best.

After reviewing the three proposals, if none of them are changed, possibly the Kemp-Kasten proposal is best as a percentage is used of each income and thereby making it more equal for low income or high income. It seems it might be the least paperwork and thereby saving citizens the large fee for an attorney or such person to figure his taxes.

Thank you once again, Larry, for this opportunity.

[The prepared statement of Mr. Bjorklund follows:]

STATEMENT BY
LYLE G. BJORKLUND, PRES. BJORKLUND FOODS, INC.
227 KASAN AVE., VOLGA, S.D.
U.S. SENATE SMALL BUSINESS COMMITTEE
FEBRUARY 13, 1985

It seems to me that most of us as Americans have been at sometime or are unhappy with the present taxation methods of our country. It is really going to be hard to ever arrive at a policy where everyone is going to be satisfied. Seems to me, as I listen to most people around me that they hate to pay taxes but I have always said "It is a good day in my life when I have to pay taxes as that means I've made some money." That, of course is getting harder and harder to do each year though.

I definitely feel that there sre too many so called "loop-holes" in our present taxation process. I have always felt that churches and church property should be taxed. There are groups who "call" themselves churches and religious organizations and buy lots of land or property and don't have to pay tax because they call themselves churches. If all churches paid taxes this would be eliminated. If churches can raise enough funds to keeep existing, I think they could be able to raise the money for taxes too. However, I feel that donations given to churches and charitable organizations should be a taxable deduction. This is the only means of survival they have and if not a taxable deduction the amounts given may be subatantially less and they would not be able to operate and survive.

As a small businessman, I definitely feel that the proposal on interest income and expense could be quite a deciding factor for someone like myself and the farmer. As it gets harder and harder to make a profit each year, we seem to have to borrow money more often. I feel that lots of us probably pay more interest than have it as an income. To use this interest expense as a deduction could leave us with more money to operate our business and keep afloat in the following year. Interest rates have become so high that is is a big factor and expense in any kind of business that one is in, including farming.

Inflation the last few years plays such a big part in business that I definitely feel that it should be taken into account in the taxation system of our country. If we can "get-a-handle" on inflation, we could solve many problems if businesses and farmers going broke and having to borrow more money each year to keep operating. A gew years ago, our state proposed and enforced a 5% decrease ao all state employment and any state funded functions and projects. Instead of having a deficit in our stae treasury, we have a surplus. Possibly something like this could be done at the federal level and thus help to slow down inflation and also help to reduce the federal deficit. The main criticism I seem to hear when people have to pay taxes is that the government is spending too much money and some of it unwisely.

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Senator Pressler. Lyle, thank you very much, and your practical experience makes this an especially valuable piece of testimony.

Let me just interject and say that the hearing record will be kept open for any additional written material that anyone, including nonwitnesses, may wish to submit about either personal income taxes, business income taxes or farm income taxes. I wanted to say that.

I know there are members of one or two classes here dropping in, and I welcome you because we do need the thoughts of our young students also.

Next we shall hear from Jack Danz of the Lakeside Dairy of Sioux Falls.

Jack.

STATEMENT OF JOHN F. DANZ, PRESIDENT, LAKESIDE DAIRY CO., SIOUX FALLS, SD

Mr. Danz. Thank you, Senator.

I kind of feel like I am in a unique position here. I am what you call a middleman. You have had Burton up here, one of my good grade A producers, and now sitting to my left you have one of my good customers in Volga.

I have been caught as a middleman, as a processor in the same squeeze that they have been caught in. I would be very, very happy if I could say that I had a half a percent of my sales as profit before taxes and 1 percent I would jump with joy.

I have reviewed each of the three tax proposals and I find it very difficult to arrive at a conclusion that one plan is better. There are parts of each that are good and some that are bad. I believe that we should have an indepth study made of each of the aspects of the three proposals before we state a definite opinion.

I think that Congress should bear one thing in mind, that small business is the life blood of our economy. I think that a family business must have the ability to pass the business on to younger members of the family and still have an income for older members of the firm by paying a dividend without double taxation.

This is probably the major problem of the family business or family farm is that to have a profitable company you must have a good cash flow, it must be maintained to be healthy to proper and to grow and to offer employment to people.

But at the same time we just have a healthy transition to the older members of the family. I believe that the long-term capital gains under the present law should be maintained and a reasonable program for charitable contributions should be maintained.

The President has asked that the private sector accept the responsibility for the social programs in our community. Without a reasonable program our nonprofit organizations will suffer and the responsibility will fall back on greater Federal programs.

I feel that the tax-free income on State and local government bonds should not be repealed. Perhaps it should be tightened. But without this entirely, many communities would have a hard time attracting new industry to their community.

I believe that employer provided fringe benefits for their employees should be retained. I don't believe that my employees or any other employees on their present wages can stand the cost of these fringe benefits such as health insurance and life insurance.

Therefore, it if it repealed, we will have social problems because of the lack of health insurance or life insurance for many people.

I think a serious look should be taken at the following before any changes are made: depreciation system; inventories; business deductions for travel and entertainment; investment credits; and accounting methods. They all can have a very serious effect on the growth and the successful operation of a small business.

On the personal side I believe that some of the proposals made should be studied before the changes are made in them because they will affect the quality of life of the American people that we are so accustomed to and, if repealed, could encourage further Federal programs such as interest deductions, income averaging, child and dependent care credits, State and local tax deductions, and medical expenses.

In my written testimony I haven't said anything about the vehicles, but I do have 135-plus vehicles in our organization. Twenty-two of them are cars or pickups assigned to sales people that travel an area between Marshall, MN, and Rapid City. Most of those people travel 7 days a week and they represent our company 7 days a week, 24 hours a day wherever they go.

We have logged their miles since January 1. The maximum of personal miles that we have had in any of those logs is 10 percent, and a good share of that 10 percent is driving to and from work, and many of them live 20 or 30 miles from our regional office or our central office, and many of those miles, as I say, when they go to a community effort or occasion they represent our company. So we feel that this is something that they are entitled to. That is just one of the problems that goes with running the business, and this logging is a very cumbersome burden to us.

That ends my testimony, Senator.

[The prepared statement of Mr. Danz follows:]

STATEMENT OF JOHN F. DANZ, LAKESIDE DAIRY CO.

U.S. SENATE SMALL BUSINESS COMMITTEE HEARING ON TAX REFORM PROPOSALS, WEDNESDAY, FEBRUARY 13, 1985.

MY NAME IS JOHN F. DANZ, PRESIDENT OF LAKESIDE DAIRY COMPANY, SIOUX FALLS, SOUTH DAKOTA.

I HAVE REVIEWED EACH OF THE THREE PROPOSED TAX REFORM BILLS AND I FIND IT VERY DIFFICULT TO ARRIVE AT A CONCLUSION THAT ONE PLAN IS BETTER. THERE ARE PARTS OF EACH THAT ARE GOOD AND BAD.

I BELIEVE AN INDEPTH STUDY MUST BE MADE OF THE ASPECTS OF THE THREE PROPOSALS BEFORE STATING A DEFINITE OPINION.

I WOULD LIKE TO GIVE MY THOUGHTS ON TAX PROVISIONS WHICH SHOULD BE PART OF ANY TAX PROGRAM THE CONGRESS MAY ADOPT.

1. CONGRESS SHOULD BEAR IN MIND AT ALL TIMES THAT SMALL BUSINESS IS THE LIFE BLOOD OF OUR ECONOMY.

2. A FAMILY BUSINESS MUST HAVE THE ABILITY TO PASS THE BUSINESS ON TO YOUNGER MEMBERS OF THE FAMILY AND STILL HAVE INCOME FOR OLDER MEMBERS OF THE FIRM BY PAYING DIVIDENDS WITHOUT DOUBLE TAXATION. THIS PROBABLY IS THE MAJOR PROBLEM OF FAMILY BUSINESS, WHETHER IT BE A FARMING OPERATION OR SOME OTHER TYPE OF BUSINESS. THE CASH FLOW OF THE COMPANY MUST BE MAINTAINED FOR HEALTHY OPERATION, TO PROSPER AND GROW, TO PROVIDE EMPLOYMENT, BUT AT THE SAME TIME PROVIDE HEALTHY TRANSITION FOR OLDER MEMBERS OF THE FAMILY.

3. LONG TERM CAPITAL GAIN UNDER THE PRESENT LAW SHOULD BE MAINTAINED.

4. A REASONABLE PROGRAM FOR CHARITABLE CONTRIBUTIONS SHOULD BE MAINTAINED. THE PRESIDENT HAS ASKED THE PRIVATE SECTOR TO ACCEPT THE RESPONSIBILITY FOR THE SOCIAL PROGRAMS IN THE COMMUNITY. WITHOUT A REASONABLE PROGRAM, OUR NON-PROFIT ORGANIZATIONS WILL SUFFER AND THE RESPONSIBILITY WILL FALL BACK ON GREATER FEDERAL PROGRAMS.

5. TAX-FREE INCOME ON STATE AND LOCAL GOVERNMENT BONDS SHOULD NOT BE REPEALED ENTIRELY, PERHAPS TIGHTENED. WITHOUT THIS ENTIRELY, IT WILL BE HARD FOR COMMUNITIES TO ENCOURAGE NEW INDUSTRY.

6. EMPLOYER PROVIDED FRINGE BENEFITS SHOULD BE RETAINED. I DON'T BELIEVE OUR EMPLOYEES ON PRESENT WAGES CAN STAND THE COST OF INSURANCE PROGRAMS. THEREFORE, IF REPEALED, WE'LL HAVE SOME SOCIAL PROBLEMS BECAUSE OF LACK OF HEALTH AND LIFE INSURANCE FOR MANY PEOPLE.

7. A SERIOUS LOOK SHOULD BE TAKEN AT THE FOLLOWING BEFORE ANY CHANGES ARE MADE:

1. DEPRECIATION SYSTEM
2. INVENTORIES
3. BUSINESS DEDUCTIONS FOR TRAVEL AND ENTERTAINMENT
4. INVESTMENT CREDITS
5. ACCOUNTING METHODS

THEY ALL HAVE A VERY SERIOUS EFFECT ON THE GROWTH AND SUCCESSFUL OPERATION OF SMALL BUSINESS.

ON A PERSONAL SIDE, I BELIEVE SOME OF THE PROPOSALS MADE IN REGARD TO THE FOLLOWING SHOULD BE CAREFULLY STUDIED BEFORE CAHNGES ARE MADE BECAUSE THEY SURELY COULD AFFECT THE QUALITY OF LIFE THE AMERICAN PEOPLE ENJOY AND IF REPEALED, COULD ENCOURAGE FURTHER FEDERAL PROGRAMS.

1. INTEREST DEDUCTIONS
2. INCOME AVERAGING
3. CHILD AND DEPENDENT CARE CREDIT
4. STATE AND LOCAL TAX DEDUCTIONS
5. MEDICAL EXPENSE

Senator **Pressler**. Thank you very much, Jack.

Next I will call on Tom Batcheller, a good friend who is president of Zip Feed Mills.

Tom.

STATEMENT OF THOMAS J. BATCHELLER, PRESIDENT, ZIP FEED MILLS, INC., SIOUX FALLS, SD

Mr. **Batcheller**. Well, thank you, Senator.

I appreciate the opportunity to appear before you at this field hearing.

My comments will be brief. They will touch on the following.

How the three proposed tax reform and simplification measures, the Treasury proposal, the Bradley-Gephardt proposal and the Kemp-Kasten proposal will affect Zip Feed Mills regarding tax rates, depreciation rates, investment tax credit and capital gains.

Second, my overall assessment of the three proposed tax simplification measures.

Zip Feed Mills is a capital intensive company operating in a capital intensive industry. We are a private corporation completing our 47th year of business having been founded by my father Paul Batcheller on March 1, 1937.

We operate three manufacturing facilities in Sioux Falls, SD, Huron, SD, and Grandin, ND, as well as two retain grind and mix elevators in Huron, SD, and Yankton, SD, and one unit train loading facility in Huron, SD. We have 21 delivery vehicles allocated amongst these six operating units of our company. We utilize $5.5 million in total assets, $2 million of which are fixed assets.

Last year we generated gross sales of almost $24 million. We utilized the reserve method for recognition of bad debts and inventories are costed on a first-in/first-out basis.

As a capital intensive company there is no doubt in my mind but that the adoption of any one of the three proposed tax measures would have a significant and adverse effect on our operating profit.

As a result of changes in depreciation rates, the elimination of investment tax credit and the less favorable treatment of capital gains, the reduction in the corporate tax rates from the present 46 percent maximum to a proposed 30 to 35 percent maximum under the various proposals would not offset these losses.

Last year we acquired $509,000 in property, plant and equipment additions. We recorded $402,000 in depreciation expense. Investment tax credit totaled $26,700 for us.

In spite of the above, we as a company were able to generate less than a 1 percent profit after taxes on our sales. Reduction in the benefits of depreciation and capital gains coupled with the elimination of investment tax credit would only serve to further impair our ability to achieve profitable results on our operation and therefore further inhibit our ability to generate capital for replacement and expansion.

The concept of tax simplification in and of itself has appeal to me both as an individual and as a business manager. I am intrigued by the idea that lower tax rates as a result of broadening the base would reduce abusive tax shelters. Investments would then be made for investment purposes as opposed to investments for tax shelter purposes.

As an agri businessman I am aware of the fact, painfully aware of the fact that some of the provisions of our present Federal income tax system have encouraged urban professionals to shelter their off-farm income by getting into farming operations and thereby pushing up land prices and driving down market prices for grains and livestock.

However, I am also very much aware of the realities of our present political process wherein each of our 435 elected Representatives and 100 Senators are heavily lobbied by special interest groups.

The bottom line is tax simplification and will only come about after a great deal of discussion, debating, lobbying and as a result tinkering with the present proposed measures.

As a result, I offer for your consideration the following:

Most business people understand our current tax laws, including capital gains, depreciation, investment tax credit and so forth. We have experienced three significant tax changes in the last 4 years, those being the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act, TEFRA, in 1982 and the Deficit Reduction Act in 1984.

I suggest that Congress could give us tax simplification by simply allowing us as small businessmen to work with the existing tax rules and regulations for more than 12 to 18 months before passing another piece of significant tax legislation that would require us to adopt a whole new set of rules and regulations for us to live with and work with.

Thank you.

[Applause.]

[The prepared statement of Mr. Batcheller follows:]

STATEMENT OF
THOMAS J. BATCHELLER, PRESIDENT
ZIP FEED MILLS, INC.
before
SENATOR LARRY PRESSLER

SENATE SMALL BUSINESS COMMITTEE
FIELD HEARING

On issues related to

THE IMPACT OF TAX REFORM PROPOSALS ON THE SMALL BUSINESS ECONOMY

February 13, 1985

My comments will be brief. They will touch on the following points:

(1) How the three proposed tax reform and simplification measures, namely, the Treasury Department Proposal, the Bradley Gephart Proposal and the Kemp-Kasten Proposal will affect Zip Feed Mills regarding tax rate changes, depreciation rates, investment tax credit, and capital gains.

(2) My overall assessment of the three proposed tax simplification measures.

Zip Feed Mills, Inc. is a capital intensive company operating in a capital intensive industry. We are a private corporation completing our 47th year of business, having been founded by my father, Paul Batcheller on March 1, 1937. We operate three manufacturing facilities in Sioux Falls, South Dakota, Huron, South Dakota, and Grandin, North Dakota, as well as two retail grind and mix elevators in Huron, South Dakota and Yankton, South Dakota and one unit train loading facility in Huron, South Dakota. We have 21 delivery vehicles allocated amongst these six operating units of our company. We utilize 5½ million dollars in total assets, 2 million of which are fixed assets. Last year we generated gross sales of almost 24 million dollars. We utilized the reserve method for recognition of bad debts, and inventories are costed on a first-in, first-out basis.

As a capital intensive company, there is no doubt in my mind but that the adoption of any one of the three proposed tax measures would have a significant and adverse affect on our operating profit. As a result of changes in depreciation rates, the elimination of investment tax credit, and the less favorable treatment of capital gains, the reduction in the corporate tax rates from a present 46% maximum to a proposed 30 to 35% maximum under the various proposals would not offset. Last year we acquired $509,000 in property, plant and equipment additions. We recorded $402,000 in depreciation expense. Investment tax credit totalled $26,764.

In spite of the above, we as a company were able to generate less than a 1% profit after taxes on our sales. Reductions in the benefits of depreciation and capital gains, coupled with the elimination of investment tax credit would only serve to further impair our ability to achieve profitable results on our operation, and therefore, further inhibit our ability to generate capital for replacement and expansion.

The concept of tax simplification in and of itself has appeal to me both as an individual and as a business manager. I'm intrigued by the idea that lower tax rates (as a result of broadening the base) will reduce abusive tax shelters. Investments would then be made for investment purposes as opposed to investments for tax shelter purposes. As an agri-businessman I'm painfully aware of the fact that some of the provisions of our present federal income system have encouraged urban professionals to shelter their off farm income by getting into farming operations, thereby pushing up farm land prices and driving down market prices.for grains and livestock.

However, I'm also very much aware of the realities of our present political process wherein each of our 435 elected representatives and 100 senators are heavily lobbied by special interest groups.

The bottom line is tax simplification will only come about after a great deal of discussion, debating, lobbying, and as a result, tinkering with the proposed measures.

As a result, I offer for your consideration the following:

Most business people understand our current tax laws, including capital gains, depreciation, investment tax credit, and so forth. We have experienced three significant tax changes in the last four years, those being the Economic Recovery Tax Act (ERTA) in 1981, the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982, and the Deficit Reduction Act (DEFRA) in 1984.

I suggest that Congress could give us tax simplification by simply allowing us as small businessmen to work with the existing tax rules and regulations for more than 12 to 18 months before passing another piece of significant tax legislation that would require us to adopt a whole new set of rules and regulations for us to live with and work with. Thank you.

Senator **Pressler**. Well I think that is an excellent statement, and let me say that Senator Packwood has said that we shouldn't have a new tax bill this year, that we haven't even fully implemented the regulations from the last one. There is a strong feeling along those lines and you have reflected that very well in your statement.

Let me ask each of you as small retailers, one issue before us is the accounting of inventories and the method of reporting that in the accounting system. I know that it plays a big role in ultimately determining the taxable income of a business. In your opinions what changes should we make in the accounting of inventories, if any, or do any of you have any strong feelings about that?

Mr. **Nyberg**. I don't have any strong feelings about that, Senator, primarily because if you use consistency you know where your inventory levels are.

I will say that a number of years ago I went with LIFO and I very deeply feel if I hadn't gone to the LIFO method my cash flow would have been diminished to where I wouldn't have had the growth. So I still don't understand why a lot of people don't go from FIFO to LIFO. I understand that there is some discussion in these rules here to simplify the FIFO method, and from experience for myself I would say for the benefit of those that find it cumbersome to change, it is beneficial.

Senator **Pressler**. Another issue that is frequently brought up is that in the service industries it is argued that depreciable property is not used as much. I mean there are some businesses that don't have as much depreciable equipment as others.

Of course none of you are in a service industry. All of you provide a service, but you have inventories. Is this something that should be equalized? Do any of you have any strong feelings on that?

Mr. **Danz**. On the depreciation schedule?

Senator **Pressler**. Yes.

Mr. **Danz**. Depreciation is very important in our business. The type of equipment that we have, the life of a bottling machine is about 5 years. When you talk about a bottling machine you are talking about something that cost a quarter of a million dollars. They are all stainless steel and they are all very expensive. So we need the rapid depreciation schedule and from our fleet standpoint also.

When you run 135 trucks and they travel 50,000 and 60,000 miles a year, each of them, we need the rapid depreciation schedule to keep a healthy flow in our business.

Senator **Pressler**. Lyle, I was very intrigued with your statement on charitable contributions. Charitable contributions are a very sticky wicket, and in fact if we had a pure flat rate tax they would be eliminated altogether.

In your testimony I believe you suggested that church property should be taxed but the contributions should continue to be deductible. Is that where you come out?

Mr. **Bjorklund**. Yes.

Senator **Pressler**. The difficulty we have, and I might address this to all of you, is that there are different types of charitable contributions. One is a person who genuinely gives a $50 charitable contribution to some charity, writes a check and sends it in. What has happened is that a lot of this is abused in the sense of an event held to raise money, for example, charity concerts.

You may read in the paper that a million dollars was raised to fight cancer, but an audit would indicate that maybe very little actually went to cancer because the band was paid or the transportation of the band was paid. They had one case where one of these famous rock groups was flown from England. A lot of charity balls that we see in Washington, will raise about $35,000, but there will be about half that in expenses.

I suppose at all levels you have to have events sometimes to raise money, but of course now if you start having regulations for all this you are getting into many more regulations and people to enforce them and where do we draw the line. Do any of you have any light to shed on that?

Mr. **Bjorklund**. Well, I was thinking in our local area we had a family there that had an auction sale. They claimed they were a church group and the people said that none of that money was taxable. And we have other small groups that start up and they buy a lot of land and take it away from other people and they claim they are church groups and I think they should be paying taxes on these groups and it would eliminate some of this.

Senator **Pressler**. Well, one of the things that I feel strongest about is some of these groups that call themselves church groups that really are not. And of course we in Congress have tried to change it. The Supreme Court a few years ago made a ruling that made it very difficult for Congress to regulate this area.

But the definition of church group and some of the activities that they can engage in economically is much too broad. So I think that your point there is well taken.

Let me say that the issue of the loss of credits and deductions called for in each of these major reforms is supposedly offset to some degree by reductions in individual and corporate tax rates.

But as Tom Batcheller pointed out, I think on his first page, that all three of these plans would have an adverse effect on the operating profit and he goes on to say that as a result of changes in the depreciation rates, the elimination of the investment tax credit and less favorable treatment of capital gains, even with a reduction in the corporate tax rates from a present 46 percent maximum to the proposed 30 and 35 percent, you would be worse off; is that correct?

Mr. **Batcheller**. Yes.

Senator **Pressler**. And would that be true of most small businesses?

Mr. **Danz**. I would say so, yes. Investment credit is very important to us.

Senator **Pressler**. Well, I think that is a significant point because it is assumed under each of these that those would at least balance out and it is even implied that they might even benefit businesses.

Mr. **Batcheller**. Senator, I think the key is the fact that I look at our operation and we are a very capital intensive business. I look at a lot of businesses looking at as an example a lawyer, the legal profession. They are dealing with very few assets. They are selling a service and they require a little office space and a typewriter or word processor I guess today and they are in business.

I think the key to this is dealing with investment tax credits and dealing with depreciation. We are talking about assets. When you are talking about a very capital intensive business such as the business that I am in or the business that Jack is into, farming is a very capital intensive business. Then they are going to have a much greater and much more adverse impact or effect on their operation with these various tax proposals. Depreciation and investment tax credit become much more of a factor in our types of operations than they would in others.

Senator **Pressler**. OK.

Mr. **Nyberg**. I would like to speak to that, if I might. I think you have to keep in mind that the incentive tax credits came about in trying to get the economy generated again in 1981. Up until that time we really didn't have what you might call a tax incentive credit. I am not talking about depreciation. I think depreciation carries its own weight depending upon whatever the item is and what the length of time the machinery can produce.

If Jack has to have 5 years on stainless steel bottling machines, that might have to be left that way. My point is that with incentive tax credits you are advancing and taking up-front expenses and you are going to lessen your tax exposure. Whereas if that is reached out over a longer period of time, you are just deluding, you might say, or delaying your tax benefits.

So for myself, other than getting the economy going for what it was intended to do, I feel that I am still recapturing my investment through depreciation depending upon the period of time that that item can be deferred to.

Senator **Pressler**. I might call on my two colleagues to see if they have any questions that I haven't covered.

Mr. **Hudson**. First of all, I would make just one comment relative to what Roy said on payroll taxes. Payroll taxes are something of a separate issue, an important issue, and to the extent that we reduce spending for programs that are funded by the Social Security or Medicare, if we choose to do so, that would reduce the taxes. But that is what you have to do to reduce those taxes.

The first question I would have, which I address to everyone, is it seems the number of small business owners do not do their own taxes so that you have to rely on some outside advice. The question would be do you have to rely on that outside advice, is it more or less costly than it used to be and do you think more about taxation than you used to? Is it something that concerns you more than it used to?

Mr. **Nyberg**. From my background I am an accountant and that was my profession. When I first came out of high school I was a controller for a million dollar ready-to-wear women's ready-to-wear back in 1950, and I can assure you with that background I am not capable of doing my own tax work. I do have an accountant and it is not inexpensive. I mean they do get their fees.

I think in talking with my accountant, and I have coffee with him every morning, it just so happens he is my coffee buddy, they are against the flat tax rate, and they are against it I presume because their jobs would probably be less.

Mr. DANZ. I very definitely have a public accountant that I use. I could never follow what I would have to do as far as our accounting is concerned. So we have a public firm that does our accounting.

Mr. BJORKLUND. I am the same. We have an accountant that does our work for us, but it would be nice if we could get rid of all the loopholes so we could do it ourselves.

Mr. BATCHELLER. I am with the majority. We have an accountant that does our work as well. We have concerns from a couple of standpoints. I think the laws are so complex that you are concerned are you leaving too many dollars on the table and are you getting everything properly accounted for. I think our laws are just so complex in this day and age that if we were to be good accountants and if we had the capabilities of doing our own tax returns, we probably wouldn't have the time to devote to our businesses.

Mr. HUDSON. Well, I take it from your earlier statements, too, that these costs are more than what they used to be.

Mr. BATCHELLER. That is correct.

Mr. HUDSON. The second question I would have to anyone who wants to answer it is you mentioned a lot of loopholes in the law, and one way you can address that is to write a very complex provision that is designed to tighten all those loopholes. Another option is to adopt a straight flat tax which would be a change from the current progressivity of our Tax Code. But how would you feel about one flat rate on all small business income?

Mr. BATCHELLER. I would like to comment on that. If we were truly to look at one flat tax, the only problem that I think Congress would have to deal with is to properly define what the income is. Once we have determined what income is, then that in turn would lead to what our tax rates are.

I think every one of these proposals calls for, as an example now, and I know I am going to upset a few folks here, but the home owners' deduction. This country ever since I have been around has had a tendency to have the saver subsidize the borrower. I think part of the reason that farming is in as much trouble today as they are is the fact that our inflationary economy and the psychology that we were using called for leveraging, called for working with other people's dollars to grow bigger and to leverage your operation.

All of a sudden about 4 or 5 years ago we turned the tables and we changed the game plan. And these folks that were out there that were highly leveraged, they just came tumbling down and we have still got folks today that are in that same predicament. They were working with other people's money.

Other countries have a tendency to support the saver and encourage people to save. I think the IRA's are a step in the right direction here. But the home owners' deduction really is a means of encouraging people to borrow again and back to where we were before.

If we could look at defining income and then determining that rate of tax, whether it is one rate or two rates or three rates, but get away from all deductions, then we would truly have tax simplification I think.

Senator **Pressler**. What about following up on the spousal IRA for a nonworking wife, so to speak. I mean the farmers earlier this morning wanted a spousal IRA for farm wives, but there would be an enormous loss of revenue, though not as great as increasing the individual exemption $2,000.

Mr. **Batcheller**. Well, I look at the IRA's and I think this is the first meaningful thing that Congress has given the American people to encourage savers to save dollars. That coupled with the fact that we have inflation, you know with inflation at the rate that it is right now, there is a real and positive reward for saving dollars. Back 5 years ago when the rate of interest that you could earn on a deposit, on a time deposit was 5 or 5¼ percent and the rate of inflation as running in double digits. This saver was doing nothing but subsidizing the borrower.

And in response to the spousal IRA the spouse is a very key and a very important part of any household, whether it is on the farm or in the city, and I think their contribution has to be recognized. I would endorse a spousal IRA for a nonworking spouse.

Mr. **Nyberg**. Senator, can I address that point?

Senator **Pressler**. Certainly.

Mr. **Nyberg**. I believe that the IRA is going to be the valve to help Social Security. If we had when I started paying Social Security tax in 1938 when the moneys that I had paid into the fund had been credited to me and then the moneys that maybe the business had put in had been used for the social purposes of it, just think where we would probably be today in relationship to having some sense and balance to what was credited to me.

If I were to go back over the last 26 or 27 years that I have been paying not only my share, but also the company's share, I have paid into that fund personally well over $100,000 and, like I say, I am still 7 years away from even beginning to think of taking Social Security.

Senator **Pressler**. So I think Tom's point, on the saver subsidizing the borrower, is that in this case we are giving some recognition to the saver.

Mr. **Nyberg**. Yes.

Senator **Pressler**. I think you have a question here.

Mr. **Walsh**. One question for Mr. Batcheller and Mr. Danz because of your comments on the accelerated depreciation.

Earlier we had some testimony indicating that accelerated depreciation might lead to a boom or bust cycle, and I take it that from your experience you wouldn't agree with that, either one of you?

Mr. **Danz**. Well, in our business, in the packaging business and the merchandising, those things change every day. Just as an example, in our company in the last year and a half our capital expenditures exceeded $2 million because we had to update our refrigeration equipment, we had to update our packaging equipment and we had to update our fleet. This is a cycle that we go through. If we are going to be an aggressive processing company and give South Dakota a dairy processing plant, we have to keep up with our competition and with the change in our industry, and it is very important.

Mr. **Batcheller**. I guess my own personal opinion on accelerated depreciation, I think there was a time and place for accelerated depreciation. I think it was much more necessary when we were dealing with double digit inflation. If we are not dealing with double digit inflation, if we can buy something and 5 years from now know that the price is not going to be three times what it is today, then it lessens the necessity for accelerated depreciation.

Mr. **Walsh**. One other question on the investment tax credit. It has been criticized by some people as merely a subsidy for taxpayers who are going to do whatever they do anyway. If they are going to buy a piece of equipment, they are going to buy it anyway regardless of the investment tax credit. Would you agree or disagree with that?

Mr. **Nyberg**. To some extent. I think it might have helped again during the time that the economy was turned down. I remodeled and spent $150,000 remodeling that entire store right at the end of 1983. So I was ahead of the game to get going thinking that things were going to come out of it. So I invested $150,000 and got some accelerated depreciation. I was going to do it anyway, but I think it helped me start sooner.

Mr. **Batcheller**. And I would have to tend to agree with Roy. I think there are cases where not all investments are going to be made. If we were to lose investment tax credit, a number of investments would continue to be made. But there are a number of investments that one of the key factors in determining whether or not to make that investment is the investment tax credit implication.

Senator **Pressler**. Gentlemen, we could continue this for some time. We may have some questions for the record for you, but our time is moving along. So I am going to thank you very much for taking the time out from your important duties and call the next panel.

Thank you very much.

[Applause.]

Senator **Pressler**. Next I shall call forward our final panel. We have Dr. Raymond Ring, associate professor of economics, School of Business, University of South Dakota, and we have Milt Mehlhaf from the First National Bank of Freeman. Bill Rigsbee is not here. He will be submitting written testimony. He is chairman of the board of Midland National Life Insurance.

So I will call Milt and Ray forward if they are both here.

Milt, we thank you very much for driving up from Freeman and we look forward to your testimony very much.

I am not sure that Ray is here yet. He was coming.

From the floor. He was here earlier.

Senator **Pressler**. He was here earlier. I hope we haven't lost him.

In any event, Milt, why don't you go ahead and give your testimony and we will proceed.

STATEMENT OF MILTON T. MEHLHAF, PRESIDENT, THE FIRST NATIONAL BANK, FREEMAN, SD

Mr. **Mehlhaf**. Thank you, Senator.

Senator Pressler, I wish to thank you for giving me this opportunity to participate as a witness on behalf of small businesses and farmers in regard to tax reforms and simplification.

I would hope that in your deliberations on tax reporting simplification and reforms that it would not result in tax increases for our farmers and small businesses, but rather that it puts us all in a more equitable position percentagewise with the larger firms, corporations and high-salaried individuals.

As I took a look at some of the provisions of these three proposals, I see the Treasury proposal not as a simplification but rather as an increase again in taxes for the small corporations, both farmers and businesses.

The small family farm, the so-called Mom and Pop operation was always advised to incorporate because of limited liability and some advantages in taxes; but the Treasury plan is another step backward for our family type farms.

Let me give you a case in point. A small corporation with a profit of $25,000 under the present system pays $3,750 in taxes. Under the Treasury plan it would pay $8,250, an increase of 120 percent.

Let's take another situation, the Mom and Pop corporation have a profit of $100,000, and under the present setup their tax would be $25,750, but under the Treasury plan it would be $33,000. It is still an increase of 28 percent. But you will note that the percentage is decreasing as the profits become larger and, in fact, the larger corporations will have a substantial decrease in taxes over the present system.

A corporation with a profit of $1 million, which incidentally is not our typical Mom and Pop operation in South Dakota, under the present system would pay a tax of $439,750. But under the Treasury plan that tax could be decreased by as much as $175,000, depending on the dividends they would pay. This would be approximately a 40 percent decrease over the present system.

I am concerned about the small family type operations, businesses and lower income individuals and feel that the larger firms, corporations and high salaried individuals should be paying the same taxes percentagewise as the small ones. Let's attempt to keep it that way as you consider reforms and simplification.

Another provision that requires some serious thought is the bad debt reserve. The Treasury plan eliminates the bad debt reserve method by going to actual losses. This would make it virtually impossible for banks and other financial institutions to adjust to changing economic conditions. With the bad debt reserve management can make allowances for possible future losses in those years when they have income and the wherewithal to make those allowances.

It seems to me that through these many years that financial institutions have used good accounting in determining bad debt reserves and it is very unlikely to me that they are making unrealistic high provisions for loan losses just to avoid paying taxes.

Changing to the experienced method income for taxation will fluctuate more sharply than at present. Income will be less in bad years and more in good years. These fluctuations will make it more difficult for Government to estimate what taxable income will be.

The reserve for bad debts method I believe tends to flatten the peaks and valleys of year-to-year income through both bad and good cycles.

Therefore, I would urge you to support and keep the bad debt reserve method as shown in the Kemp-Kasten plan. Under the present plan State and municipal bonds are tax free, and we feel that should remain. To tax this income would eliminate the favorable interest rates now enjoyed by State and local governments and would ultimately curtail needed municipal improvements, school building and modernization programs, et cetera.

I note that all three proposals would fully tax income from unemployment compensation and workers' compensation. I wholeheartedly agree that this should be done under the reforms since some have more take-home pay than some who put in a full day's work. They also are privileged with the many government services and protection and should pay their fair share.

One final point I would like to make is on the personal income taxes. The Bradley-Gephardt and the Kemp-Kasten proposals would make no change in the present law on personal, charitable contributions, and that is the way it should be.

The Treasury plan would discourage contributions with the two percent floor and would put a hardship on churches, schools, hospitals and other charitable organizations.

In conclusion, I urge you to come with a good simplification system and reform by doing away with the many brackets now in use and put all levels of income taxed at the same percentage regardless of low, middle or high income. And I feel that the Kemp-Kasten plan with some modification comes closest to that.

Thank you, Senator Pressler.

[The prepared statement of Mr. Mehlhaf follows:]

STATEMENT BEFORE THE U.S. SENATE SMALL BUSINESS COMMITTEE

STATEMENT BY:

Milton T. Mehlhaf, President, The First National Bank
4th and Poplar St., Freeman, South Dakota
Before Subcommittee on tax reforms
Senate Small Business Committee
February 13, 1985

Senator Pressler, Chairman Weicker and members of the Senate Small Business Committee. I wish to thank you for giving me this opportunity to participate as a witness on behalf of small businesses and farmers in regard to tax reforms and simplification. I would hope that in your deliberations on tax reporting simplification and reforms that it would not result in tax increases for our farmers and small businesses, but rather that it puts us all in a more equitable position percentage wise with the larger firms, corporations and high salaried individuals.

As I take a look at some of the provisions of the three proposals I see the Treasury proposal as not a simplification, but rather as an increase again in taxes for the small corporations, both farmers and businesses. The small family farm, the so called Mom and Pop operation was always advised to incorporate because of limited liability and some advantages in taxes, but the Treasury plan is another step backwards for our family type farms. Let me give you a case in point. A small corporation with a profit of $25,000.00 dollars under the present system pays $3,750.00 dollars in taxes--under the Treasury plan it would pay $8,250.00 dollars, an increase of 120%. Lets take another situation, the Mom & Pop corporation have a profit of $100,000.00 dollars, and under the present set-up their tax would be $25,750.00 dollars, but under the Treasury plan it would be $33,000.00 dollars. It is still an increase of 28%, but you will note that the percentage is decreasing as the profits become larger and in fact the larger corporations will have a substantial decrease in taxes over the present system. A corporation with a profit of $1,000,000.00 dollars (which incidentally is not our typical Mom and Pop operation in S.Dak.), under the present system would pay a tax of $439,750.00 dollars but under the Treasury plan that tax could be decreased by as much as $175,000.00 dollars depending upon the dividend they would pay. This would be approximately a 40% decrease over the present system. I'm concerned about the small family type operations, businesses and lower incomed individuals and feel that the larger firms, corporations and high salaried individuals should be paying the same taxes percentage wise as the small ones. Lets attempt to keep it that way as you consider reforms and simplification.

Another provision that requires some serious thought is the bad debt reserve. The Treasury plan eliminates the bad debt reserve method by going to actual losses. This would make it virtually impossible for banks and other financial institutions to adjust to changing economic conditions. With the bad debt reserve, management can make allowances for possible future losses in those years when they have income and the wherewithal to make those allowances.

It seems to me that through these many years that financial institutions have used good accounting in determining bad debt reserves and it is very unlikely to me that they are making unrealistic high provisions for loan losses just to avoid paying taxes. Changing to the experience method income for taxation will fluctuate more sharply then at present. Income will be less in bad years and more in good years. These fluctuations will make it more difficult for government to estimate what taxable income will be. The reserve for bad debts method, I believe, tends to flatten the peaks and valleys of year-to-year income through both bad and good cycles. Therefore I would urge you to support and keep the bad debt reserve method as shown in the Kemp-Kasten plan.

Under the present plan State and municipal bonds are tax free and we feel that should remain. To tax this income would eliminate the favourable interest rates now enjoyed by State and local governments and would ultimately curtail needed municipal improvements, school building and modernization programs, etc..

I note that all three proposals would fully tax income from unemployment compensation and workers compensation. I wholeheartedly agree that this should be done under the reforms since some have more take home pay then some who put in a full days work. They also are privileged with the many government services and protection and should pay their fair share.

One final point I would like to make is on the personal income taxes. The Bradley-Gephardt and the Kemp-Kasten proposals would make no change in the present law on personal-charitable contributions and that is the way it should be. The Treasury plan would discourage contributions with the 2% floor and would put a hardship on churches, schools, hospitals and other charitable organizations.

In conclusion I urge you to come with a good simplification system and reform by doing away with the many brackets now in use and put all levels of income taxed at the same percentage regardless of low, middle or high income and I feel that the Kemp-Kasten plan with some modification comes closest to that.

Thank you.

Senator **Pressler**. Thank you very much, Milt.

You are a small town banker who sees these issues every day. I think the examples are probably illustrative of some of your clients on Main Street down there, and I appreciate that very much.

I will have some questions a little bit later.

I call now on Ray Ring.

Thank you very much for coming up.

We welcome you here and appreciate very much your coming.

STATEMENT OF RAYMOND J. RING, JR., ASSOCIATE PROFESSOR OF ECONOMICS, SCHOOL OF BUSINESS, UNIVERSITY OF SOUTH DAKOTA

Mr. **Ring**. Senator, thank you for asking me to testify on tax reform.

Tax reform I believe should be divided into two separate and conceptually independent, although perhaps not politically independent, issues. The first is tax simplification and the second is tax rates.

I would like to first discuss simplification or base broadening. Because other participants here today are directly involved in small business, they are better qualified than I to discuss how each individual element of simplification is likely to affect particular industries, firms or geographic areas.

I would like, instead, to concentrate on some of the more general effects that might be expected, not because I think the specific considerations are unimportant, but because I want to concentrate on those areas in which I as a public finance economist feel most knowledgeable.

One substantial gain from tax simplification will be reduced compliance costs. The latest issue of the National Tax Journal reports a recent study of the costs of complying with Federal and State individual income taxes. The authors of that study estimate that it costs taxpayers, depending on their methodology, $17 to $27 billion per year just to comply with Federal and State income tax laws. That is 5 to 7 percent of the taxes collected, and information I have seen on other taxes, like the sales tax, we are usually talking more like 2 or 3 percent of the cost of the tax collected. And these estimates don't even measure the cost of employers' withholding, corporations' compliance costs or Government collection and enforcement costs.

Compliance costs are especially high for small business. Self-employed persons in the same survey reported spending an average of 57 hours a year working on taxes. They estimated their average compliance costs at over $800 per year. Eighty-seven percent of them sought professional tax help.

All of these costs are just as real, whether they are paid in dollars or in hours, as the taxes themselves. An economist discussing tax reform I recently heard say "tax lawyers and accountants create not a single widget." I am following up on his statement now trying to figure out the complicated tax system doesn't feed or cloth anyone. If the tax system were less complicated, those same people could be using their competence and their cleverness in education, management or any of a myriad of other productive pursuits.

Another major gain from tax simplification would be a more productive use of our economic resources. The market should reflect the resource use that best satisfies people's desires as expressed through their ability to buy goods and services. Prices should signal that best use and induce investors to pursue that best use.

However, a tax system that greatly rewards some uses of capital and penalizes other uses independently of the market interferes with that system. When some firms or some entire industries face much different effective tax rates than do others, the investors put resources where they produce the highest after-tax return and not where they produce the most desired goods and services.

These influences can certainly also affect small business. Rapid depreciation and special treatment of capital gains, for example, do provide breaks for small business investment and reward for risks taken and thus encourage those activities. However, the same breaks may also put small businesses, including many in South Dakota, at a disadvantage. For example, if tax shelters were eliminated, would capital that now goes into oil exploration, apartment buildings or other shelters instead come to South Dakota, or not leave the State in the first place?

To cite another example, and this has already been addressed earlier today, do nonfarmers buy farmland for its tax advantages, but in the process bid that land away from smaller family farmers who might use it more productively and probably also more responsibly.

I hope these more general but less directly noticeable benefits are not overlooked in the tax reform debate. Persons or organizations that stand to gain or lose substantially from a proposed measure will make sure they are heard, and well they should, while those with only a small potential gain may feel that the gain doesn't warrant their involvement. Nevertheless, small gains per person spread over many persons—and potentially over the entire society—can result in very large overall gains.

The fact that per person gains are small is further compounded by their being difficult to measure and sometimes hard to detect and, as a result, I am afraid there may not be a very strong constituency out there for those small per person gains.

Another problem with the current system is tax evasion. A couple of weeks ago, I had a student in my office complaining that he thought almost no one in high income classes paid taxes, and I tried—and I am not sure how successful I was—to convince him that high income people do pay tax, though maybe not as much tax as he thinks they should pay. The fact that people with the same incomes pay much different amounts of tax, and this has already been discussed also, strikes many people as even more unfair.

I turn now briefly to the second major element of tax reform, the rate structure. The lower statutory rates made possible by simplification will be available to everyone who pays taxes and not just to those that can take advantage of special provisions. It is important that we each evaluate very closely how we will be affected before we conclude that we will be hurt by tax reform. Many of the businesses that first reacted negatively to Treasury's proposal found upon further reflection and more careful examination that they wouldn't be hurt after all.

Finally, some brief comments on progressivity. Most Americans feel that the tax structure should be progressive. In light of all the recent changes that have reduced the effective progressivity of the overall Federal system, including increases in payroll taxes and reductions in income-based transfer programs, retaining the current progressivity seems the minimum necessary to meet the express desires of most Americans for tax progressivity.

Under any tax reform some will win and some will lose. If reform is revenue neutral, the dollar amounts lost will offset the amounts won. We should be concerned about how each of us as individuals will fare under tax reform, but our concern must go beyond ourselves to other persons, to the State and to the Nation.

More efficient resource use will ultimately benefit all of us and those who come after us. And, further, if tax reform improves the way we look upon our tax system and the Government it supports, I think we will all win even more.

Thank you, Senator.

[The prepared statement of Mr. Ring follows:]

STATEMENT BY
RAYMOND J. RING, JR., ASSOCIATE PROFESSOR OF ECONOMICS
SCHOOL OF BUSINESS, UNIVERSITY OF SOUTH DAKOTA
SENATE SMALL BUSINESS COMMITTEE
February 13, 1985

I want to thank you for asking me to testify at this hearing on tax reform. Tax reform can be divided into two separate and conceptually independent--although perhaps not politically independent--issues. The first is tax simplication; the second is tax rates. It is important to make this distinction explicit because so much of the recent discussion has been couched in terms of a "flat tax" when a flat rate structure is not essential to tax simplification and, in fact, none of the proposals with which I am familiar includes a truly flat rate.

I would like to first discuss simplification. Because of time limitations, I will limit my remarks to some of the more general effects of tax simplification. Other participants here today are directly involved in small business and therefore better qualified to discuss the more specific gains and losses to be expected from each individual element of simplification. This does not mean that I think these matters are unimportant. I simply prefer to concentrate on those areas in which I as a public finance economist feel most knowledgeable.

One substantial gain from tax simplification is reduced compliance costs. The latest issue of the National Tax Journal reports on a recent study of the costs of complying with Federal individual income taxes. The authors of that study estimate that it costs taxpayers $17 - 27 billion per year to comply with Federal and state income tax laws. That's about 5 - 7 percent of the taxes collected. About seven-eighths of that is the value of the time the taxpayers themselves spend in keeping records, etc.; most of the rest is paid to professional tax preparers. No attempt was even made to measure the added costs to employers of withholding taxes, etc., corporations' compliance costs, or governments' collection and enforcement costs. Such costs are especially high for small business. Self-employed persons reported spending about 57 hours a year working on taxes. Eighty-seven percent of them seek profession tax advice. They estimated their total compliance costs at over $800 per year.

All of these costs are just as real--whether paid in dollars or in hours--as the taxes themselves. They are, in economists' parlance, a dead-weight loss. Time spent in record keeping would be better spent in production or leisure. As an economist discussing tax reform said recently, "tax lawyers and accountants

don't do what they're paid to do or don't do a good job. It does mean that trying to figure out a complicated tax system doesn't feed or clothe anyone. If the tax system were less complicated, those same people could be using their competence--and cleverness--in teaching, managing, or any of a myriad of other productive pursuits.

Another major gain from tax simplification would be more productive use of our economic resources. The best use of a resource--that is, the use that best satisfies people's needs as expressed through their ability to buy goods and services--should also be the most profitable. The market should, through the pricing mechanism, signal the best use and induce investors to pursue it. However, a tax system that greatly rewards some uses of capital and penalizes other uses, independently of--sometimes even contrary to--economic considerations interferes with that system. The signals are at best confusing, at worst wrong. The fact that some firms, and some entire industries, face much different effective tax rates than do other firms and industries creates incentives for putting resources where they produce the highest after-tax return, instead of where they produce the most goods and services.

The implications are clearly significant for small business. Rapid depreciation and special treatment of capital gains, for example, do provide breaks for small business investment and reward for risks taken, and thus encourage those activities. However, these same breaks may also put small businesses--including many in South Dakota--at a disadvantage. For example, does capital that would otherwise come to South Dakota--or not leave the state in the first place--because it would be more productive here, instead go into oil exploration, apartment buildings, or any of a myriad of other uses because even though those pursuits are less productive, they are more profitable after taxes? To cite another example, do nonfarmers buy farmland for its tax advantages and in the process bid that land away from smaller, family farmers who might use it more productively--and probably also more responsibly?

I hope these matters are not overlooked in the tax reform debate. Persons or organizations--however many or few they may be--that stand to gain or lose substantially from a proposed measure will make sure they're heard, while those with only a small potential gain may feel that the gain does not warrant their involvement. Nevertheless, small gains per person spread over many persons--potentially over the entire society--can result in very large overall gains. The fact that per person gains are small--although total gains may be great indeed--is further compounded by their being difficult to measure and sometimes hard to detect. As a result, there may be no "constituency" to be heard on these matters.

Another aspect of tax simplification that deserves mention is tax evasion, which has become quite serious. Many people think the Federal tax system is exceedingly unfair and that that somehow justifies lying in order to lower their own taxes. Only a couple weeks ago a student was in my office complaining because he thought almost no one in high income classes pays taxes. I tried to explain to him that high income people may avoid more taxes than he thinks they should, but they do pay, and that the Federal individual income tax is on average progressive, although probably not as progressive as he would like it to be. The fact that people with the same incomes pay much different amounts of tax strikes many people as even more unfair. Elimination of many tax preferences would go far in reducing these concerns.

I now turn briefly to the second major element of tax reform, the rate structure. The "return" to everyone from tax simplification will be substantially reduced rates. That "return" and whatever incentive it may create for saving, investment, and work effort will be available to everyone who pays taxes, instead of just to those who can take advantage of special provisions because of the characteristics of their industry or their success in pressing for special tax treatment. It is important that we each evaluate very closely how we will be affected before concluding that we will be hurt by tax reform. Many of those businesses that first reacted negatively to the Treasury proposal found upon further reflection and more careful and detailed examination that they would not be hurt after all.

Finally, I turn to the question of progressivity as opposed to a single, "flat" rate for all persons, whatever their incomes. Most Americans feel that the tax structure should be progressive and this is tacitly recognized in the rate structures of all the major proposals. The Treasury proposal, for example, is supposed to retain approximately the same progressivity as the present system.

Under any tax reform, some will win and some will lose. If reform is revenue neutral, as most proposals claim to be, the dollar amounts lost will offset the amounts won. We must be concerned about who the winners and losers will be, and about how each of us as individuals will fare. But I hope our concerns will go beyond ourselves to other persons, the state, and the nation. More efficient resource use will ultimately benefit all of us, and those who come after us. If tax reform improves the way we all look upon our tax system and the government it supports, we will all win even more.

Senator **Pressler**. Thank you very much.

I very much appreciate both of your testimonies.

One thing I would like to address to either or both of you is that much has been said about a perceived bias in favor of large rather than small business in the current Tax Code. Of course, you have got to have some income in order to take advantage of certain deductions or you have got to make some investments that take advantage of depreciation.

Do you think this bias exists and do you think any of the reform proposals corrects it, either or both of you?

Mr. **Mehlhaf**. I think it does exist. For example, some of the other panel members alluded to this, and I am thinking strictly about the farmers of course. You have people who are so-called farmers that aren't really the dirt farmers out there. I feel that that has hurt our farming more than anything else.

It has taken away from that farmer who really goes out there and works day and night to raise livestock and produce grain to produce the food stuffs for the world. And yet some guy or some corporation can go out and buy 35,000 head of cattle and as much as say hey, we don't care if we lose $35 to $40 a head. It does something for our particular farmer out here in South Dakota, our small time farmers, and we are all small farmers. We are all together on this.

Senator **Pressler**. That is a fine, fine statement.

Professor Ring points out something we frequently overlook. We always say that the tax incentives will attract money to a certain type of activity. However, at the same time it attracts it away from other types of activity. For example, in a lot of our big cities there are many condominiums built and office buildings built, not because there is a need for them, but because they are a good tax shelter, and there has been an overbuilding oddly enough of certain types of structures.

So when the argument is used that a tax break or a tax incentive will encourage investment into something, by its very nature it is silently encouraging it away from something else. I think that is a very eloquent point you make Dr. Ring.

Mr. **Ring**. And to maybe try to expand a little on that, Senator, the point is that while we may be encouraging investment, the question is, are we encouraging investment and at the same time distorting market decisions so that perhaps in terms of productivity—and I am not saying this is happening, I am not enough of an empirical type to say this—but are we distorting the market to the point that we are using more resources for inefficient means, and that perhaps the net effect is negative.

I am not saying it is happening, but I think it needs to be considered and it needs to be examined whether, yes, we are encouraging more investment with maybe the wrong types of investment.

As far as housing goes, I haven't seen so much recently, but a couple of years ago there was kind of a mini-spate of studies done by economists in which they tried to address the question of whether all of these various provisions, including the deductions on personal returns for property taxes and mortgage interest, whether that was encouraging so much building of owner occupied residences that it was drawing capital away from private sector investment—plants and equipment—and could be at least a partial explanation for the slow investment and slow growth that we were seeing in the late 1970's. Again, that is an issue that I think ought to be addressed.

I am like the person in the panel before this, I know you make some people mad as soon as you start talking about the deduction for mortgage interest, but as a nonbusiness person I feel a little freer to say that because that would be the biggest deduction I would lose if we took that one away.

Senator **Pressler**. Milt, you commented on the fringe benefits. For example, the airlines give some of their employees free tickets which are not taxed. The employees of a school might give the professors' children free tuition, or a farmer might give a hired hand a place to live and food, which is not taxable, or a corporation might provide an employee with a car which is used only for business purposes.

I think you were suggesting that we should find a way to tax some of these things, but without extensive recordkeeping requirements it is hard to do sometimes. And I am very much against the current rule that requires everybody to write down every business trip they take in their car because I think we can get a percentage or formualte a better way of going about it.

Do you have any clear line on these fringe benefits, if we can call them that, or is that what you were addressing?

Mr. **Mehlhaf**. Well, I think the fact that IRS now had demanded farmers to log every mile, which I think is absolutely ridiculous. Every time that farmer gets into the pickup and goes to town for example to pick up some repair parts and then perhaps has to go over to another farm to discuss a cooperative method between two farmers, I think it is absolutely ridiculous and uncalled for.

I guess the things I would refer to is the misuse of it by some of the larger corporations. This is fine to have a certain amount of these fringe benefits that are deductible, but let's face it. Some of the cocktail hours, the membership to club associations and so forth, I think they are overdone, and we out here in South Dakota don't enjoy those kind of privileges. It is a pattern for the big city people, the large concerns out east, and I think they should be taxed on some of those. I don't believe they should be entitled to all these fringe benefits. That is what I am thinking about.

Senator **Pressler**. Good. I think you are right. The perks of some of those jobs are almost as valuable as the salary, which indicates the problem we have gotten ourselves into.

Let me also ask you about State and municipal bonds. You suggested that they remain tax free. Now, indeed, there are many things done and there is much employment provided. The question is would that same employment be provided if we had a universal end to that. I know we have got to cut spending and so forth, but we still have an enormous need for more revenue and many of our State and local governments have a surplus. But should the Federal Government allow certain types of economic activity to go on untaxed while over here it is being taxed if it is done privately.

Do you see a possible phasing out of this or do you think it is something that is so important that we should keep, and I might address that to both of you. That is tough question.

Mr. **Mehlhaf**. Well, let me answer that on the part of the local small community. I think that it would be very difficult if you took away the tax free bonds for a small community to build hospitals, schools, modernization and improvements in their particular cities if you took this tax free system away.

You and I know that every time we channel something through Washington and send the money out there, by the time it gets back to the local governments everybody else has had their hands in it, and I don't think that we need that kind of a situation. Let our local governments take care of their situations as long as it is a tax free thing. They do get some favorable interest rates and they can continue to improve those particular things I am talking about. I would hate to see that being changed.

Mr. **Ring**. I guess I need a point of clarification first. Do most of the proposals want to remove all tax-free bonds or just industrial revenue bonds from the deduction?

Mr. **Hudson**. Most of them it is industrial development bonds.

Mr. **Ring**. Just the industrial development bonds, OK. I guess my comment would be to go back to the distortions again. If that is a criterion that we want to follow, to try to avoid using the tax system to distort the market, then providing an exemption for that particular type of activity—whatever it is and it happens to be financed through Government, whether it is development bonds or hospitals or whatever—violates that.

Now if we decide that there are certain policy reasons to encourage certain types of government activity, and therefore not be so concerned about distortions—that is what we are doing every time we try to encourage any kind of activities, we are distorting the market if we are using taxes to do that—then I guess I would say we ought to keep those deductions.

I think we should weigh whether we want to introduce one more distortion like that and decide whether that is a policy choice we want to make.

Senator **Pressler**. Let me also ask each of you a question, and I will play devil's advocate here because I am very much for limiting these nonfarm people who are taking advantage of tax writeoffs and especially big corporations that are breaking up land out West.

But let me ask the question, and it is a two-part question. No. 1, how do you distinguish between the normal worker who is earning money and living on a farm and is trying eventually to own that farm and another category might be a person who works at another job, a doctor in town who has a small farm that is an income producing farm but likes to live out there and work in town? That is point No. 1.

How do we protect that fellow who is trying to eventually become a farmer. It was pointed out that in many counties about half the income is nonfarm income and people are holding on by having jobs elsewhere, and if we don't allow them to deduct some of these things, they probably couldn't survive. So I throw that out to you first as the first scenario. How do we resolve that?

And the second problem is that some certain farmers and ranchers, it is said, acquire capital by getting a partner who has money to invest which they can't get in any other way. It is kind of a reverse argument, but how would you deal if you were writing the Tax Code, how would you deal with those two problems?

Mr. **Ring**. I really don't have any clear-cut answer. That is one of those areas where we can talk principles or criteria all we want, but when you get down to the brass tacks, unless some kind of rather arbitrary dividing lines, 50 percent income from one source or the other or something like that, at least at this point I can't really go any further than that in saying how you distinguish those people who legitimately are investing simply because it is a good investment from those who are investing because it is a tax writeoff or whatever.

Perhaps remove some of the tax writeoffs so that there is no longer that incentive for people to come into farming in order to take advantage of that in the first place, and the only people left in farming are either there because it is a good investment—economic investment, not a good tax investment, but a good economic investment—or because they love the work.

Mr. **Mehlhaf**. I just wanted to say one thing. I guess that you can't in this free enterprise system, anybody that wants to get into farming and has another business, he is entitled to do that.

I guess what I am trying to say is that if that be the case, then the tax committee should take a look at taxing it as a separate entity rather than simply saying we are going to get this farm here, buy this land out here to use it as a tax writeoff and raise cattle or hogs or whatever it may be, we really don't care.

If it is handled as a separate entity and taxed that way, I don't think anybody has any qualms about that. Everybody has a right to do what they wish in this country and that is great. I think that is wonderful in a free enterprise system.

Senator **Pressler**. We have a question in the audience, and we will call on you in just a minute. Just let me ask Professor Ring one more question.

On the investment tax credit, if that were eliminated, what impact would that have across the board? Would people still make the same investments pretty much?

Mr. **Ring**. No; not the same investments. The question would be would they make the same level of investments, and that is one that is an empirical question that I am afraid I can't answer.

I guess the question, and I sort of tried to address it in here, is if we eliminated investment tax credits but can offset that with lowered rates for everybody, will those perhaps offset one another, and I think we should consider that.

Certainly some people who because of their industry or whatever can take advantage of investment tax credits now will probably end up losing on that. But perhaps to try to maybe make a silk purse out of a sow's ear, perhaps what that is doing is removing some of the distortions that existed in the first place.

Senator **Pressler**. Professor Ring, I was very appreciative of your testimony. I gather that you feel that the problem with these tax simplification plans is that they are not really simplification. They are a little bit, but by the time we get through with them they are going to be just as complicated. You are talking more in terms of the ideal. I mean the ideal thing that we see presented in the 60-second news capsule is that we are going to eliminate all deductions and exemptions and have flat rate tax and everybody pays the same rate.

But are you satisfied with these three proposals or do you think that we are just opening the door and getting back into the same old thing with all the various conditions that are under each one?

Mr. Ring. If the proposals were adopted essentially intact, I guess I don't think that we would be getting back to the same old thing because except for a few deductions that if I had my druthers, at least as an economist worried about efficiency, I wouldn't allow those either, but at least those that are proposed are more straightforward. I don't think we would be getting back to the same old thing because I think we would, in fact, have simplification, maybe not as much simplification as we could have, but still significant simplification.

I think that an offshoot advantage of that would be that it would hopefully at least for a few years remove the incentive for Congress to come in and change things every year and all the problems that that causes.

I think it is interesting to go back to the 1954 Tax Reform Act, and I think it is still true, it was when I was in Washington, that we still talk about the Internal Revenue Code of 1954, as amended. There was a major change then, apparently, and almost no changes in the Tax Code—with the exception of a few changes in rates and that sort of thing—very few until about, I think, the 1969 Tax Reform Act, and then it was a few years, maybe 1974 or so, before we got another one.

Now, as you indicated earlier, we don't even get to implement one change before we are changing things again. It seems to me that this major overhaul may be necessary so that we get away from jerry-rigged system and we are not always trying to fix it and often, I think, messing it up even more as we try to fix it.

Senator Pressler. I think that is a very good point and, indeed, the last paragraph of Tom Batcheller's testimony, an earlier witness, said that maybe the best thing would be to leave the code as it is for a period of time, and if we are going to change it to make sure it is not amendments every year because the IRS poorly implements regulations.

Let me ask you both one more question. Under all three of the major tax reform proposals, the preferential tax treatment for capital gains would be reduced or eliminated. What impact do you see that having?

Mr. Ring. I feel like I am repeating myself here. I feel, again, that special treatment of capital gains probably does encourage investment, but it may sometimes encourage investment in the wrong directions.

If we could tax capital gains along with all other income in the same way, that is probably going to require, if we have anything other than a flat rate, some kind of income averaging.

Some of the reasons for exempting 60 percent and one of the past reasons that was always given was the fact that so much of it was inflation. If we do indeed have a handle on inflation now and that is no longer a problem, then I think one of the arguments for exempting part of the capital gains is gone and I think it comes down to a question, again, do we want to do something specifically to encourage capital investment and, if so, is that the best way to do it?

Mr. MEHLHAF. I would pretty much agree with that, too. I think you do have to follow the inflation rate. If it does that, then of course I believe that changing capital gains would be in line.

Senator PRESSLER. Let me ask you both one more question and then we will have a question from staff here.

We hear a lot about the cash economy through which a lot of people are not paying taxes. They get paid in cash from some kind of a job and it is not reported. Increasingly tax rates are so high that people are taking more and more cash or barter. I will fix your teeth if you will fix my backyard sort of thing.

There is one professor from New York, and I think he is from NYU, who estimates that we may have about 20 percent in the cash economy. That is very high. In other words, citizens are feeling so frustrated by the Tax Code that they are taking advantage of the situation of not reporting income and there is very little that the IRS can do to trace it.

That is not much of a problem in our State because we don't have people who get tips of a total of $20,000 or $30,000 a year, which a lot of people seriously get at many of the resorts and hotels and so forth, and we don't have many taxi drivers and others who are paid completely in cash.

What about that problem? The answer sometimes given is that we should then have an ad valorem tax as they do in Europe so that if you buy products you pay a tax and you are bound to pay. How do we get around the cash problem?

Mr. MEHLHAF. I don't see that as much of a problem out here in South Dakota, but I am sure in some areas that they have ways of avoiding taxes through cash, and I am sure probably out here, too, for that matter. But again it comes back to the individual and how honest are they about reporting their taxes.

Your example of the IRS having people log their miles. If the guy wants to lie, he can lie. You are not going to get extra tax dollars because of that. It is again dependent upon that individual.

Mr. RING. I am afraid that is as much a matter of social mores, and I am not sure how we change those. As far as the tax system goes, I think that reducing rates and reducing that feeling among people that everybody else in the world is getting by legally on taxes and the only way I can do it is by cheating a little bit, and particularly once they have found that that works, I don't know how you get the genie back into the bottle and get people to begin to comply again. I think that may be a problem.

But I think if we can make the tax system appear, and it probably now appears more unfair than it is, but if we can make it appear much more fair, a lot of people would then say "OK, I am certainly willing to carry my share. It is just that I object to all these other people who aren't carrying their share." Then I think some of those problems would probably go away, but probably not all of them.

Senator PRESSLER. Well, I thank you both very much.

Why don't you just stay there.

We had a hand back here. We would like to hear you, but if you prefer we will take it in writing, whichever you prefer.

From the Floor. Well, I think that if they are tilling the soil and doing the chores, they are not tax sheltering. It is pretty simple.

Senator **Pressler.** OK. So that should be the criterion, if they are actually farming the land.

From the Floor. That is just my thought.

Senator **Pressler.** OK. That could be a criterion.

From the Floor. Senator?

Senator **Pressler.** Yes.

From the Floor. That remark about this bartering and so on, you know, I think that a lot of that has to do with what the dollar amounts are. For instance, if I need my teeth fixed, and I just do not have the dollars to do it and there is just no way and I am living from hand to mouth and pay check to pay check, but I know that this dentist needs his barns painted and we can work something out, I don't see any reason why that isn't acceptable in this country.

Now if we are talking about a cash situation where big hotel employees are making $10,000 on tips alone and aren't paying any taxes on it, that is a different story. But I think that we would be remiss as citizens of these United States if we tried to put the pressure on people who are making a tradeoff on services.

Senator **Pressler.** Well, it would depend on how large that tradeoff is. Of course, they can do it. I mean you can always barter, but if it is a significant amount it is to be reported as income. There are barter tradeoffs that are worth several thousand dollars which are done with the exclusive intent of avoiding taxes. I think according to the people who talk about the growing cash economy this is a problem in terms of loss of revenue.

But I would share your feelings that if somebody has no income item it obviously wouldn't be a taxable question.

From the Floor. Well, I think it has got to be a dollar view. The babysitters I can see. Goodness gracious, if a woman needs a few dollars and we are talking $100 maybe in a whole year, you know, and the kid for babysitting is paid cash and it is reported. You know, those are the kind of things. But if you are going to pass a law, then it is going to have to affect everybody, unless you can put some kind of a dollar amount on it.

Senator **Pressler.** I appreciate that very much. The tax system can't be so onerous, as this current reporting requirement is, that there is a general rebellion.

Somebody had his hand up over here. Yes.

From the Floor. All of us talk about fair taxes. Well, how can anybody be a millionaire in income and not pay his fair share of taxes under the structure that we have at the present time?

Senator **Pressler.** Pardon? How can someone be a millionaire and not pay any taxes under our current system?

From the Floor. Yes, and not pay any taxes at all? That is what they advertise.

Senator **Pressler.** Well, that situation shouldn't be, but there are cases where because of the tax credits and investment tax depreciation and so forth——

From the Floor. Our law should never be wrote up that way though. He still should pay, if it is 15-percent tax——

Senator **Pressler**. There should be a minimum tax.

From the Floor [continuing]. He should pay a minimum tax on the whole batch. If he has got the income he can afford to pay the taxes, right?

Senator **Pressler**. I don't like to see people who are millionaires not paying any taxes, and I would agree with the principle.

From the Floor. Absolutely. Like myself, I don't pay much taxes, but I pay my fair share, you know, which I gladly do because I have got food and shelter and everything that I want in life and why have more.

Senator **Pressler**. Do either of you have any comment on that?

Mr. **Mehlhaf**. No.

Mr. **Ring**. No.

Senator **Pressler**. Yes.

From the Floor. I would like to know why the Government could not get completely out of writing the tax laws on depreciation, investment credit and accelerated depreciation and the whole schedule and let everybody go back to supply and demand and a profit motive for doing business and charge them a lower rate of tax on their profit and eliminate all of it.

Senator **Pressler**. That is the flat rate of tax.

From the Floor. Yes, but I mean eliminate all the depreciation, all the shelters, everything. Like he was saying on the new tax, a big corporation will pay less dollars per the amount of profit that he makes and a smaller farmer will pay more. If you eliminated all the deductions, all the depreciation and instead of charging 30, 40 or 50 percent, go back to a 10- or 15-percent base and everybody pays it.

Senator **Pressler**. Do either of you have any comments on that?

Mr. **Ring**. It sounds like he is talking about simplification in its purest form.

Mr. **Mehlhaf**. That is what people want, I believe. That is what they are after. [Applause.]

From the Floor. That's right.

Mr. **Mehlhaf**. Investment credit, for example, and I know this through the farmers. Man alive, it was a tax thing. I know that some of these guys shouldn't have been buying machinery, and they did during those years because of the investment credit.

From the Floor. But a business, if the profit is there the business will buy the equipment that they need to do business with.

Mr. **Mehlhaf**. Right, and so will the farmer.

From the Floor. They don't need the investment tax credit to buy it. If the demand is there for their product, they will buy it. But if you tax them 30 or 40 percent, there is going to be no business. It will be dead. But if you lower your tax rate back down where every business will pay it, the economy will grow.

Senator **Pressler**. Yes.

From the Floor. On this tax shelter where people buy land. Just try and farm a hunk of ground where they don't want to make any money and see where you are at.

Senator **Pressler**. Yes.

From the Floor. I am not a farmer, but I would like to have been. The Government chased my Dad off the farm in the late 1950's by allowing him only 25 percent land and cash crop in

Kansas. So my heart is still a farmer. You don't take the farm out of the boy.

But when I see Standard Oil buying up land all the way around the North Dakota farmland, I think Standard Oil has no business in there. They wouldn't like it if farmers came and bought Standard Oil out from under them.

The other issue is I am less concerned about how people are taxed but how our Government uses the taxes. We put people in prison for bad checks and our Government has bankrupted our country for the next hundred generations.

Senator **Pressler**. Does anybody else have a comment?

[No response.]

Senator **Pressler**. We are running against a time bind here. I want to thank our witnesses very much.

Incidentally, if any of you have any comments for the written record, your statements as made today will be placed in the record.

We appreciate very much you coming and many have stayed the course.

I thank you very much. I think the testimony we have received has been detailed and very useful, particularly the prepared statements. Each person who testified made some very good analyses and I shall take them back and the Small Business Committee will be making some recommendations later regarding small business, agricultural, individual, and other types of taxes to the Finance Committee.

Also, the Small Business Committee has a legislative function. We will take these things into consideration in the legislation that we pass, and we are very appreciative of the people who came.

Thank you very much.

[Whereupon, at 11:48 a.m, the committee recessed, to reconvene at 2 p.m. in the Fine Arts Building Auditorium, Huron College, Huron, SD.]

[Material follows:]

FNB

FIRST NATIONAL BANK
P. O. BOX 910
PHILIP, SOUTH DAKOTA 57567
605-859 2525

February 12, 1985

Larry Pressler
Room SR-407A
Russell Senate Office Building
Washington, DC 20510

Dear Larry:

In response to your request for information on the current farm debt situation concerning our rural towns and cities, along with the farmers, I submit the following:

1. There is a real problem facing rural United States. You have received all kinds of estimates as to the size of the problem and I would add that I beleive 20% of the farmers and ranchers will not be able to come out of this current situation. They will take with them, in some cases, their lenders and their suppliers. Another 30% or more of the farmers and ranchers are just in the margin as to making it.

While the problem is nationwide, some areas of agriculture are not currently affected. However, as more and more farm loans cause losses to their lenders (i.e. the Federal Land Banks), the lenders will be forced to raise interest rates and this will affect relatively healthy farmers and their lenders. Also, the impact on manufactors of equipment and suppliers of farm items will cause increased costs to the healthy farmers.

In closing on this subject, I would say if the present trend of large numbers of farmers forced to sell out continues at a rapid or worse, a faster pace, the situation will run out of control with perhaps 20% of the Agricultural banks going down, with them maybe all the community and on a national level, the entire Farm Credit Administration.

2. What can be done about the problems? The answer is not to loan more money to the farmer with too much credit at the present time. We must have some help from the Federal Government along with cooperation by borrowers and the lenders. In other words we must find a solution to the rapid selling off on capital items (i.e. land and equipment) and stablize the markets.

The current FMHA programs are too small and fall far short of the necessary scope to stablize the situation. I am not for a total bail out to the lenders and the farmers. I support the proposal of the ag committee of the American Bankers Association and I enclose a copy herewith. This proposal would be a sharing of the hurt by the farmer first, the lender second and the Federal Government last.

In addition, I believe the Agricultural lenders need an incentive to continue to provide credit in an orderly manner to farmers and additional protection to insure safety and soundness of the credit systems. I would propose the IRS code be changed to allow lenders of ag credit to add to their reserves for bad debts 5% of their total ag credits and ag related credits. This would allow the lender to develope the necessary protection to carry the farmer and farm related business.

I also believe this incentive would put more lenders into the market and provide for an orderly transition from the current farm credit problems. I do not believe this would cause much loss of revenue to the U.S. Treasury as the increased tax free reserve would come from changing investments from the tax free to taxible. The tax free reserve idea was used in the 1930's and continued until the early 1970's. I do not believe the larger reserve allowance should be permanently tax free, but it should be allowed for long enough for the current farm problems to work itself out.

3. What can be done for a long term solution to the farm problems? We must bring interest rates down! Almost everyone in the country agrees the current federal deficit is the major reason present rates are high. If the current federal deficit was cut, rates would come down, the dollar would drop and farm exports would increase. In other words, farm costs would go down (i.e. interest rates) and farm prices would increase as exports increased. This, I believe, is the only long term solution that will work.

Yours very truly,

Charles W. Ekstrum
President

CWE:cb

Pressler Hearing on Taxes

I could favor flat tax but as you stated - Not if it is going to be a bigger mess.

① Investment credit - I would not miss it. you can't use it if you don't Have a profit. I do not buy new machines just To get Investment Credit.

② tax Sheltered farming feeding etc. Should try To Eliminated. They create an unfair situation for most farmers. If they are Tilling the soil or doing The Chores they are not tax-sheltering.

③ Income Averaging - ← what I raised my Hand about

The farmer needs it because of weather and The unstability of the markets.

Capital gain is not very important To me

④ Fringe Benefits.

If They are not Taxed, Then The farmer should be allowed To deduct Them as an expense - (Hospital Ins. workmans Comp Ins)

⑤ Depreaciation

I would favor going back to letting Person decide what To do but favor simple 10 year an machinery and 25 years on Buildings.

⑥ tax Law –

Make it simple - easy to read + fill out / Poor can't use them. Plug loopholes for wealthy.

⑦ I wouldn't mind paying taxes if I had a real Profit. Investment Credit + depreciation are to me a paper profit.

⑧ These Things could be worked into Present Tax structure.

⑨ There is getting to be a large number of people doing buisness for Cash - Paying No Tax.

Liked Toms thoughts about Leveraging + Changing game Plans

Good hearing Larry -
Good Pannels -

Vernon D. Andersen
R1 Box 189

AFTERNOON SESSION

Huron, SD.

Senator PRESSLER. I want to thank you all for being here and say that I apologize for being late. The hearing this morning ran late and this one will, too, probably, and I will stay and visit with people who have particular problems.

We will move the hearing right along but, first of all, let me say that it is a pleasure to be here. We have read some of the things in the paper about the progress that the college is making and also to be here in Huron where we have worked on a number of projects, Federal projects and local projects in trying to be of assistance.

Yesterday I was in Pierre at the farm rally and was very impressed with the turnout and with the goodness of our people and their great problems.

I welcome with open arms the publicity they are bringing to the problems in agriculture and I am fighting very hard for the kind of credit and price situation that will help our State. The key to it I think lies in an expansion of the Food for Peace Program and expansion of exports, a renewal of the target price program and some emergency credit. It will be very difficult with the size of the budgetary deficit to do much in terms of additional appropriations.

But if we can make whatever programs there are apply to smaller farms, that will be much more applicable to South Dakota because a lot of these payments went to huge operations.

Let me also say that I know there is a class of students from Iroquois I believe here. Are they here?

[Show of hands from the audience.]

Senator PRESSLER. Yes, there they are. And we thank you very much for coming because this hearing today is on taxation, but it is broader than that. It deals with the agricultural problem, it deals with the small business problem and it deals with a number of other problems across the board. You will all be taxpayers and our Tax Code is one of the most complicated in the world.

As many as 60 percent of our people believe the Tax Code is too complicated. Forty percent of all Americans need to have a tax accountant to do their taxes, including myself I might say, and we really are in need of tax simplification.

So let's be careful because, as we found this morning, as some of these reform plans affect agriculture and as they affect REA's and as they affect cooperatives, and as they affect individuals, and as they affect small business, sometimes it is different than it appears and we must think those things through very carefully.

Let me also say that I know that in the audience is a former Senator, Gladys Pyle, and I am very honored that she is able to be here. I am looking around for Gladys. If she could just waive her hand.

[Former U.S. Senator Pyles raises her hand.]

Senator PRESSLER. There she is right there. How are you, Gladys? Glad to see you. A former U.S. Senator from the State of South Dakota. We are very honored to have you here. [Applause.]

I see many prominent business people here and educators, and this is a hearing of the Small Business Committee of the U.S.

Senate. It is technically on the tax reform proposals that are being considered.

I think one of the first steps that we will have is just a briefing. You can't see these charts very well. But we have got these charts on sheets of paper, and I guess we have run out. We had a large turnout this morning at a hearing and maybe people can share them.

Maybe I could call on Stewart Hudson at this time, who is a professional staff member with the Small Business Committee, to give us about a 5- to 10-minute briefing on the three tax plans that have been proposed. Now I don't know if any of them will be adopted. Some people say we should just stick with the tax bill we have got because the IRS hasn't even implemented regulations for the last one completely. Other people say we should go completely to a flat tax with no deductions or exemptions.

As you will find, these three flat-rate tax plans, the one submitted by the Treasury, another is the Kemp-Kasten plan and another the Bradley-Gephardt plan, are three different variations of flat rate taxes. But what you will find is that these flat rate tax proposals are not really flat rate taxes because they all have their favorite exemptions and deductions in them ranging from charitable, to home owners, to a continuation of a lot of the present things. But once we open the door, then we are back in the same old situation where special interests and individual groups get their exemptions and deductions.

So that is where things stand. Before we have our first panel I think we will hear just a short briefing on what has been proposed in Washington, but I would emphasize that it will be sometime later this year before any of these pass, if they do.

I want to look very closely at the impact on agriculture and small business. Most of the analyses that have been written look upon the effect on the individual taxpayer and the effect on big business.

I would say to the students from Iroquois or to any of you, if you want to write down an idea you have to improve our tax system, do so and we will make it a part of the official record and we will keep the record open for some time.

Stu, can I call on you at this time to give a short presentation on what the three basic tax plans are that have been presented.

Mr. HUDSON. Thank you, Senator.

I want to first of all apologize that we don't have the Xeroxes ready for everyone. So you will have to bear with me, those of you that don't have those copies. Once you receive them this will all be crystal clear to you hopefully. [Laughter.]

Anyway, what the Senator said is quite correct that it should be kept in mind that none of these proposals are going to be passed next week or next month or perhaps even this year. That gives us an opportunity to hear from the witnesses we invited today, and since the record will be open, from anyone else who has an opinion on whether or not any of these tax reform proposals is something that they would prefer or whether something else ought to be done.

I want to say, first of all, to the witnesses that I know a number of people have expressed misgivings about being here given that they feel thought ought to be experts since they have read about these taxes for 2 weeks. I have heard about them for 3 weeks. So we are not that far ahead of you. A lot of these proposals are going to continue to change. So we can discuss some of the more general issues today and I will just say to not be concerned about being experts.

I would just like to point out on any of these tax reform proposals that they consist of a mixture of both desirable or undesirable provisions, depending on where you sit.

For example, on the first chart that we have here, that none of you can read, we have tax rates. Now generally when these proposals are offered, these reduced rates which are spelled out here are offered as a sweetener. The medicine over here is the loss of credits and deductions.

Now since the primary focus of today's hearing is small businesses, we will be concentrating on the rates that small businesses pay and the loss of credits and deductions that many of you as small businesses or farms or ranchers currently use.

Let me start off on the tax rates. The Senator mentioned that all of these proposals are called "flat taxes." If you look at the tax rates, that is not generally the case. For example, on corporate rates, two of the proposals call for a flat single rate of 30 or 33 percent, but the third proposal has three rates. If you look on the individual side, two of the proposals have a series of rates, like current law, and another proposal has one flat tax. So you have to really be careful about calling any of these flat tax proposals.

Now I said that those were the sweeteners. There is also a lot of medicine in all of these and you have to balance out the sweeteners and the medicine.

Capital gains is a provision that is in the current law that allows for preferential tax treatment on a capital gain. That means you don't have to pay as much tax on it generally. All of the various reform proposals would either eliminate that special treatment for capital gains or reduce it.

Now I will come back to this as it pertains to farms, but keep that in mind, that all of these proposals will change capital gains and all of them would generally result in increased taxation of a capital gain. You have to balance that again and keep going back to this, the reduced tax rates for corporations and individuals, or at least the single flat rate generally.

Second, on the credits and deductions, there is some pain there generally. You have an elimination of the investment tax credit called for by all three proposals. Depreciation, all three proposals would draw out the so-called useful life of a depreciable asset. What does that mean? That means that if now you are allowed to write a tractor off over 5 years, the proposal might, for example, say that you can only write it off over 10 years. That means each year you get a smaller amount that you can write off. The total is the same, but you might like to write it off as much as you can in the first years that you have that tractor.

Another provision that I think is crucial to small businesses and a number of people think is crucial to small businesses is direct expensing. Under current law you can write off up to $5,000 of depreciable equipment in the first year. That is something that the big boys don't care about too much because they spend millions of dollars on that kind of equipment. But for a small business $5,000 is a lot of money.

There are some other things on that page that I will get back to. There are some other provisions. We have the third page here that is described as other provisions.

One that I point out is fringe benefits. A number of the proposals would tax fringe benefits that currently aren't taxable. An example, health insurance premiums, a number of you, or your parents I should say, either receive health insurance premiums from their employer or, if they are an owner, provide them. Either way, that taxation of health insurance premiums, which currently are tax exempt, or tax free is a radical change from what we have now and it would affect people in a variety of ways.

Another example of other provisions, income averaging. Currently if the farmer has a bad year and then a good year, you can average your income over those years and figure out a tax rate that is better than if you get say a bumper crop and get socked with a big tax hike. That income averaging would be repealed by two of these proposals.

No one expects you all to keep all of these specific provisions in mind. The important message is that there are desirable and undesirable provisions and that part of this debate will be considering whether on balance a given proposal is preferable to current law.

Now I said earlier that depends where you sit. If you sit on the tractor as a farmer, there are a variety of provisions that are important to you. I can think of five right offhand.

The first two are interest expense and the second thing would be property taxes. Under current law property taxes for business property are tax deductible. That will be retained in all of these proposals. However, property taxes for individuals in some cases will not. So if it is for a business, for your farm for example, and you have a property tax that is assessed, you can rest assured that will continue to be deductible by all three proposals.

Interest expense for a business, for a farm generally is deductible. That generally would be maintained by all three proposals. One thing I would point out though is that in the administration proposal, the Treasury proposal, that there would be some adjustment for inflation, for interest expense.

What that means is if, for example, you figure your interest expense for next year is going to be $100 and there is say some 10 percent of inflation rate, then that $100 would be reduced to $90, for example. So the effect of indexing an interest expense for inflation reduces the amount you can deduct.

Now again I am talking about business expense. So keep that in mind. On business interest expense and property taxes, generally there won't be any significant change.

Now I go on to three other proposals that are important to farms and farmers, depreciation, the investment tax credit and capital gains. When you sell your property for whatever reason you generally pay a capital gains tax. As I indicated earlier, currently there is preferential treatment for a capital gains. You are taxed less on a capital gains. That would change under most of these proposals.

Depreciation, currently there is something called a useful life. That is not a life insurance plan. It is how long it takes to write off some kind of equipment. If it is a longer useful life, that means you are only allowed to write off less per year.

With the Treasury Department proposal for certain farm equipment, the useful lives are stretched out a great deal more than they are currently.

Finally, the investment tax credit, and I will use the example of a tractor again. If you buy a tractor and it qualifies as depreciable property, you can generally get a 10-percent investment tax credit. Under all of these proposals that tax credit would be eliminated.

Now again we get back to that being the medicine and keep in mind the sweetener is reduced rates generally. But you have to be careful with reduced rates. If you are a small business and you pay as a corporation, a flat rate of 33 percent might represent a tax hike. If you pay as an individual, then the tax cuts would in fact, you know, you have a 15-percent rate or a 14-percent rate, would probably result in a tax cut.

All of this again, you have to keep in mind it is all a mix of good and bad and desirable and undesirable provisions.

So having said that, I think I will turn it back now.

Senator **Pressler**. Well, thank you very much, and when we do get the materials we will pass them out.

Let me call forward the first witnesses. I am just told that we have changed the first panel to Bruce Odson, Paul Flanagan, the mayor of Huron, Hal Bisch and Joe Matthews. Apparently there was some visiting here before I came up. They will become panel 1.

Bruce Odson, president, Farmers and Merchants Bank, Huron, Hon. Paul Flanagan, the mayor of Huron, SD, Hal Bisch, of the Huron Chamber of Commerce and Joe Matthews, a friend of mine and farmer from Lily, SD. We hope this shuffling doesn't upset anybody. The mayor has to leave, but we will move right along.

Let me also say to the students here that this hearing will be an example of what Senators actually do. You might imagine that we all vote on foreign affairs all the time or are listening to the President speak, but much of the day we are in committee hearings working on the details of legislation, be it budget or be it agriculture or be it commerce or transportation or tax, and little by little hopefully we learn.

Every chance I get I hold a hearing in South Dakota to be able to take information back to Washington. The Small Business Committee will be doing some legislation, plus we will be making a report to the Finance Committee on things that we pick up.

So with that I will call on the mayor first. I think that might be appropriate.

Mayor, we thank you very much for being here and appreciate very much your taking the time to come.

STATEMENT OF HON. PAUL K. FLANAGAN, MAYOR OF HURON, SD

Mayor **Flanagan**. Thank you, Senator Pressler. I appreciate the opportunity to be here.

I am glad comments were made about the lack of expertise on the part of some of us and the misgivings that some of us had. I am sure I was one of them that expressed some concerns about that.

But I have prepared a statement that I would like to read into the record.

I think, first of all, I would like to remind the committee that we have had several massive changes to our tax laws over the last 4 years. These changes have created a great deal of confusion in the business community and of course confusion with the general public and even with the tax practitioners who prepare returns on behalf of us as individuals and the small businessmen.

As you are probably well aware, many of the changes included a provision to give the Internal Revenue Service the authority to write regulations to carry out the intent of the Congress as it relates to the changed tax laws.

As of today many of those regulations have still to be written. Consequently, it is still unclear as to exactly what the previous laws will actually mean. In other words, the full impact of the previous three bills has not been measured resulting in a business community that is totally confused. Taxpayers and business leaders are tentative when it comes to making business and personal business decisions because income tax is of course a real cost of doing business.

Consequently tax considerations become an important economic consideration, and the business community is not making decisions that they should be making because they are waiting for Congress to act on yet another tax reform bill.

There is no question that we need tax simplification, not necessarily tax reform, although that would be desirable, too, obviously, but certainly tax simplification. Our tax system is complicated to the extent that people trained and experienced in income taxes are confused as is the business community as a whole.

Therefore, I personally believe that a moratorium should be placed on all further tax bills that are introduced under the guise of simplification until we have had an opportunity to measure the complete impact of the last three major bills.

The proposals under consideration today do not, as I see them, simplify the tax system as a whole. Conversely, these proposals add to the complexity through the indexing of interest income, interest deductions, inventory values, capital gains, and depreciation.

And I do not believe, frankly, that indexing is realistic. It is confusing, it is based on averages, averages at a national level and not necessarily a local level and it is going to create inequities through inconsistent application. Indexing will require more professional assistance, more paperwork, more administration and more burdens than we have already. I believe, frankly, that indexing should be discarded as impractical and unworkable.

The possible exception to indexing might be in the area of exemptions and zero tax bracket amounts. Those items could readily be indexed by the Treasury Department and spelled out and addressed in the tax tables with no particular problem for the majority of the taxpayers of America.

I would like to say, as most of us know, the charitable organizations that we deal with today are for the most part well managed businesses, and it is essential for them to receive contributions from the general public as well as businesses and corporations.

I believe that all charitable deductions should be fully deductible with no ceilings. Additionally, certain charitable organizations, such as churches, hospitals, and worthwhile research organizations should be above the line deductions. If you choose to donate all of your income, you should have a 100 percent deduction for those contributions.

And medical expenses should be treated exactly like the charitable deductions. When people are sick and in need of medical attention it certainly seems contradictory to the American way to penalize those people by limiting the amount of their medical expense deduction. I believe they, too, should be deducted above the line, in other words, an adjustment to gross income and not an itemized deduction at all.

In the area of miscellaneous deductions and employee business expenses, the Treasury plan, as I understand it, wants to allow deduction for unreimbursed employee business expense as an adjustment only to the extent that the total exceeds a percentage of adjusted gross income.

Now if you were an outside salesman paid strictly on commissions, as I am, and you had to pay your own expenses to produce that income, would you for one minute believe that it would be fair to limit those expenses in any way? Whatever it takes to produce the income in the way of business expenses should be deducted from that income and deductible from that income.

In the area of State and local bond interests present law excludes from taxable income all interest received on bonds issued by State and local governmental entities. Apparently all three proposals would repeal this exemption from State and local government bonds that are issued for private purposes. This of course will have an adverse effect on the rural areas of America.

Industrial revenue bonds happen to be one of the real drawing points for trying to attract businesses to areas such as ours. With our agricultural economy fighting the battles that it is today, certainly the communities of South Dakota must try to find additional businesses to support and to assist us with our agricultural industry, and industrial revenue bonds are then obviously one of our primary means of enhancing businesses to consider South Dakota as a possible choice for relocation and future development.

Insofar as tax-free fringe benefits that are now enjoyed by many employees, it would appear there that the primary target is in the area of health care and group life insurance. The present law now takes into account additional taxable income for group term life policies in excess of $50,000 and, in my opinion, that is adequate.

In the area of health insurance premiums, what with the rising costs of health care, I find it very distasteful to attempt to tax those premium payments made by employers on behalf of the employees for the reasons I have mentioned before. Health problems have to be addressed as do their costs. A healthy America is obviously a productive America and we want to do the best we can to keep it that way.

So let's leave the health care cost deductions alone. Let's leave life insurance tax regulations alone. Life insurance is providing for survivors, as it has for almost 200 years in America. And it maybe puts a little less strain on the Social Security survivor's benefit programs.

Under present law income earned on annuity assets and investment income earned on life insurance policies is not currently taxed either when earned or when the proceeds are paid to the beneficiaries. This is a great encouragement to individual thrift, it always has been and should be retained.

Benefits arising out of the insurance policy should continue to be tax free with no taxes associated on any earnings within that policy to the beneficiary of the policy.

In the area of retirement savings I am of the opinion that any future tax legislation should do everything possible to encourage private retirement funds and employer-sponsored retirement funds.

I believe it is imperative and essential that we do everything possible to encourage the building and maintenance of adequate retirement funds to lessen our dependency on the Social Security System. The System was initially written into law in order to provide supplemental retirement benefits. But over the years all too many people have come to rely on Social Security as their only means of support during their retirement years and we are well aware of the current state of those funds.

As time moves on and people continue to live longer, it will be continually more difficult to maintain the current level of payments. For this reason I believe we need all the tax incentives we can develop to build personal and employee sponsored retirement funds.

The current law has made a number of changes in tax shelters. Those types of investments perhaps lack economic substance and I think that those types of investment should be scrutinized and the current law should continue to be critical of this type of an investment and look to the economic substance of the transaction rather than the tax aspects of the transaction.

As far as travel expenses are concerned, the Treasury plan would apparently place limitations on the amount of money that could be spent on overnight trips in connection with business and there is probably nothing wrong with that.

In the areas of business entertainment, there is no question but what this has been an area of large abuse over the years and certainly some things could be done to create more fairness in that area.

As far as bad debt deductions are concerned, the Treasury plan would apparently eliminate the bad debt reserve for all businesses. I am opposed to that simply because the bad debt reserve method attempts to match income and expense and it seems to be the most logical way to accomplish it.

In order to create a system of fairness, I believe we have got to quit thinking about the special interest groups. We have to set up a system of just ends and outs and tax what is left. It is that simple. If we keep that simple, we can come back to the point in time where nearly everyone could prepare their own tax return without professional outside help. We wouldn't have people studying the code and developing loopholes to try to take advantage of the system.

You will be taxed on what you have left, your income minus your expense leaving your next taxable income. The net result could be lower tax brackets and probably in the long run more taxes collected.

Thank you for the opportunity to be here.

[The prepared statement of Mayor Flanagan follows:]

STATEMENT OF HON. PAUL K. FLANAGAN, MAYOR, HURON, SD

Testimony Concerning the Three Tax Reform Proposals For Restructuring of the Tax System

I have asked for the opportunity to present my views as to the effects or possible effects of the current three proposals on South Dakota business.

First, I would like to remind the committee that we have had three massive changes to our tax laws over the last four years. These changes have created a great deal of confusion in the business community; confusion not only with the general public but also with the tax practitioners who prepare tax returns on behalf of our small businessmen. As you are probably well aware, many of the changes included a provision to give the Internal Revenue Service the authority to write regulations to carry out the intent of Congress as it relates to the changed tax laws. As of today, many of those regulations have not been written. Consequently, it is still unclear as to exactly what those previously written laws actually mean. In other words, the full impact of the previous three bills has not been measured, resulting in a business community that is totally confused. Taxpayers and business leaders are tentative when it comes to business decisions, and let's face it, income tax is a real cost of doing business. Consequently, tax considerations become an important economic consideration. Our business community is not making the decisions that they should be making because they are waiting for Congress to act on yet another tax reform bill.

There is no question that we need tax simplification, not tax reform but tax simplification. Our tax system is complicated and the people that are trained and experienced in income taxes are as confused as the business community as a whole. Therefore, I personally believe that a moratorium should be placed on all further tax bills that are introduced under the guise of simplification until we have had an opportunity to measure the complete impact of the last three major bills.

The proposals under consideration today do not, as I see them, simplify the tax system as a whole. Conversely, these proposals add to the complexity through the indexing of interest income, interest deductions, inventory values, capital gains, and depreciation. I, for one, do not believe that indexing is plausible. Indexing, first of all, is confusing. Indexing is based on averages, averages at a national level and not necessary at a local level. Indexing will create inequities through inconsistent application. Indexing will require more professional assistance, more paper work, more administration and more burdens than we currently need. I believe that indexing should be discarded as unworkable. The exception to the indexing, I think, would be in the areas of the exemptions and the zero bracket amounts. Those items can be readily indexed by the Treasury Department and spelled out and addressed in the tax tables with no particular problem for the majority of the taxpayers in America.

Most charitable organizations today are well-managed businesses, and it is essential for them to receive contributions from the general public, corporations, etc. I believe that all charitable deductions should be fully deductible with no ceilings. Additionally, certain charitable organizations such as churches, hospitals, worthwhile research organizations, etc., should all be above-the-line deductions. If you choose to donate all of your income, you should have a 100% deduction for those contributions.

Medical expenses should be treated exactly like charitable deductions. When people are sick and need medical attention, it seems contradictory to the American way to penalize those people by limiting the amount of their deductions. I believe medical expenses should be deducted above the line. In other words, an adjustment to gross income, not an itemized deduction at all.

In the area of miscellaneous deductions and employee business expenses, the Treasury Plan wants to allow a deduction for unreimbursed employee business expense as an adjustment only to the extent that the total exceeds 2% of adjusted gross income. If you were an outside salesman, paid strictly on commission and you had to pay your own expenses to produce that income, would you for one minute believe that it would be fair to limit those expenses in any way? Whatever it takes to produce income in the way of expense should be deducted from that income.

In the area of state and local government bond interest, present law excludes from taxable income, all interest received on bonds issued by state and local governmental entities. Apparently, all three proposals would repeal this exemption from state and local government bonds that are issued for private purposes. This obviously will have an adverse effect on rural communities. Industrial revenue bonds happen to be one of the real drawing points for trying to attract business to areas such as ours. With our agricultural economy in its current state, South Dakota must find alternatives to our agricultural industry. Industrial revenue bonds are then obviously a means to enhance and sweeten industry relocation and development.

Insofar as the tax free fringe benefits that are now enjoyed by many employees, it would appear as though the primary target area is in the area of health care and group life insurance. Present law now takes into account additional taxable income for group term life insurance policies in excess of $50,000. In my opinion, that is adequate. In the area of health insurance premiums, what with the rising costs of health care, etc., I find it very distasteful to attempt to tax those premium payments made by employers on behalf of the employees for the reasons mentioned earlier. Health problems have to be addressed—a healthy America is a productive America.

Let's leave health care cost deductions alone, let's leave life insurance tax regulations alone. Life insurance provides for survivors, it puts less strain on the social security survivor benefit program.

Under present law, income earned on annuity assets and investment income earned on life insurance policies is not currently taxed, either when earned or when the proceeds are paid to beneficiaries. This is a great encouragement to individual thrift, and should be retained. Benefits arising out of the insurance policy should continue to be tax free with no tax associated on any earnings within that policy to the beneficiary of the policy.

In the area of retirement savings, I am of the opinion that any future tax legislation should do everything possible to encourage private retirement funds and employer sponsored retirement funds. I believe that it is imperative and essential that we do everything possible to encourage the building and maintenance of adequate retirment funds to lessen the dependence on social security. Social security was initially written into law in order to provide for supplemental retirement benefits. Over the years, people have come to rely on social security as their sole means of support during their retirement years. We are all aware of the current state of our social security funds. As time marches on and people live longer, it will be more difficult to maintain the current level of payments. For this reason, we need tax incentives to build personal and employee sponsored retirement funds.

Current law has now made a number of changes to tax shelters, in other words, those types of investments that perhaps lack economic substance. I think that those types of investments should be scrutinized and the current law should continue to be critical of this type of an investment and look to the economic substance of the transactions rather than the tax aspects of the transaction.

As far as travel expenses are concerned, the Treasury Plan would place some limitations on the amount of money that could be spent on overnight trips in connection with business, probably nothing wrong with that. In the area of entertaining, there is no question but what this has been an area of large abuse over the years and some things can be done to create more fairness in what is deductible and what isn't deductible.

As far as bad debt deductions are concerned, the Treasury Plan would eliminate bad debt reserve for all businesses. I am opposed to that simply because the bad debt reserve method attempts to match income and expense and it seems to be the most logical way to accomplish this.

In order to create a system of fairness, we must quit thinking about special interest groups. We have to set up a system of ins and outs and tax what is left. It is that simple. And, if we keep it that simple, we will be back to that point in time where nearly anyone can prepare their tax return. They will not need outside help, they will not have people studying the code, developing loop holes and taking advantage of the system. There will not be anything to take advantage of. You will be taxed on what you have left, your income minus your expense is your net income. The net result will be that we will have lower tax brackets and probably in the long run collect more taxes.

Senator Pressler. Thank you. I wrote down several notes as you were talking and I am going to ask you some questions later.

Let me say that I think your points are excellent, and also the fact that you are on the scene as not only a businessman but as a mayor makes them more important to Washington.

Let me now call on a farmer who has been a friend of mine for a long time and I admire his thinking very much. He comes into Washington with the REA's. Joe Matthews from Lily, SD.

I would like to call upon Joe at this time.

I should have introduced the president of the college, Dr. John Reynolds. He probably went back to his office. I can't see out there. So, John, if you are out there, take a wave.

OK, Joe.

STATEMENT OF JOE MATTHEWS, OWNER/OPERATOR OF A FAMILY FARM CORPORATION, LILY, SD

Mr. Matthews. Thank you, Larry.

I am the owner/operator, along with my son Mike, of a family farm corporation, not the huge kind that is the boogieman in many of our eyes, but a means of transfer from generation to generation.

Not being an expert on tax matters, one of my greatest concerns that I would like to speak to a little bit about the Treasury, Bradley-Gephardt and Kemp-Kasten plan is how they all deal with tax shelters. I see them as probably one of the greatest threats to farming as we have known it, maybe even just as bad or it could even be worse than high interest rates.

Tax shelters reduce farm profitability by stimulating additional investment in productive capacity leading to overproduction and lower farm prices.

Tax breaks get bid into higher land prices causing even greater deficits for farmers trying to pay for land by farming it.

Tax shelters change the rules of who can compete in agriculture. Ability to exploit the Tax Code sometimes overcomes efficiency in determining who can compete.

Tax shelters generally grant a competitive advantage of high-bracket taxpayers, including corporate and nonfarm investors and very large capital-intensive farm operations.

Tax shelters unique to agriculture, such as cash accounting and defining confinement buildings as equipment to make the eligible for investment credit and 5-year depreciation invite investment by nonfarmers who can receive these benefits only by investing in agriculture.

Tax shelters encourage farms to grow and invest heavily in capital and economically punish those who don't. By encouraging rapid expansion on borrowed money tax shelters encourage risk taking, which has gotten many family farms overextended and in financial trouble, especially of recent times.

By encouraging the introduction of corporate nonfarm investment and growth by established farms, tax shelters reduce opportunities for beginning farmers who are squeezed out. Beginning farmers find it difficult to compete in a tax shelter industry because they generally lack high incomes against which to use tax breaks and they lack the money to make large capital investments in land, new machinery and elaborate facilities which generate tax savings.

With fewer farmers starting, the number of farms declines. The continuation of current policies and trends will place more farm income and control of food production in very few hands leaving little opportunity for beginning commercial farmers with increased separation of ownership, labor and management and a large number of small hobby farms.

Family farm meat production is particularly affected by tax policy. The cattle feeding industry has shifted out of the hands of farmer feeders into regions dominated by large commercial lots, many of which custom feed for tax-motivated investors. I understand currently half of all the cattle fed in our country are fed in 400 lots.

Policies which encourage elimination of moderate-sized family farms do not improve efficiency. Full economics of size can be captured at a moderate scale.

Maintaining a stable number of moderate-sized family farms allows the rural economy to support more people both in agriculture and small town business.

Tax policies should be judged in terms of where there are moving agriculture and rural communities in the long run in relation to the type of agriculture we would like to pass on to future generations.

With the desperate situation in rural America today, I can't not mention the terrible burden we are facing from the strong dollar and the deficit that is causing the present unbearable interest rates. If we could realize the devastation that the terrible military budget is putting on us alone, our whole Nation could put the brakes on this and we would dramatically reduce most of the dollar shortage problems and be able to fund many of the programs that we are so concerned about losing funding on today.

I also serve on the board of directors of my rural electric co-op where I live, Lake Ridge Electric and Webster.

I would urge that any tax law revisions considered continue to preserve the tax exempt status of the REA's. They are right now undergoing probably the most bitter attack in their 50-year history by the Reagan administration.

I, and I am sure most farm people, surely want to thank you, Larry, for your very strong support in trying to preserve this program along with many other good things.

I would like to thank you much for the opportunity of appearing here and expressing some views, and I guess I don't need to repeat the many things that you have said and have heard in the last few days about the problems that we are facing in rural America. We are all very familiar with them and they are all very real.

I am sitting next to a banker here. So how do I dare to say anything about that. [Laughter.]

But I am a board member of a little local bank and I have got to leave early to go back to a board meeting. It has been an interesting experience for about the first 8 or 10 years, but the last couple of years has been anything but that. It is in an area where I have lived all my life. I live on the farm that my grandfather homesteaded 104 years ago. I am the third generation and my son is the fourth and three little guys out there are the fifth.

I guess more than anything in this world I want to see that thing go on, or at least the opportunity for those three little guys, any or all of them, to farm if they want to. And without some very strong things done in regard to some type of reform, I wonder if they are going to have a chance to.

Serving on this bank board makes me see neighbors I have known all my life, and I wonder how long they are going to farm. I think I will resign and get home and tend to my knitting and not worry about that. But it is an interesting experience. I enjoy it, and it really has given me an insight that I didn't have before. I guess I would have said, as many of us nonbankers would have when they tell us they are having hard times, I would have thought ah, baloney, we don't believe it anyway. But I guess I know firsthand that it is a real struggle in any business now. I am sure we all know that.

I want to thank you for the opportunity of coming down here and presenting my views, Larry. Thanks.

[The prepared statement of Mr. Matthews follows:]

Statement by Joe Matthews, RR 1, Box 34, Lily, Day County, South Dakota, owner operator along with my son Mike, of a family farm corporation.

Testimony to be given Feb 13, 1985 before U.S. Senate Small Business Committee, Larry Pressler, chairman.

Not being an expert on tax matters, one of my greatest concerns about the Treasury, Bradley Gebhart and Kemp Kasten tax plans is how they will deal with tax shelters. I see them as probably one of the greatest threats to farming as we've known it - maybe even just a little worse than high interest rates.

Tax shelters reduce farm profitability by stimulating additional investment in productive capacity, leading to over production and lower farm prices.

Tax breaks get bid into higher land prices, causing even greater deficits for farmers trying to pay for land by farming it.

Tax shelters change the rules of who can compete in agriculture. Ability to exploit the tax code sometimes overcomes efficiency in determining who can compete.

Tax shelters generally grant a competitive advantage to high bracket tax payers including corporate and non farm investors, and very large capital intensive farming operations.

Tax shelters unique to agriculture, such as cash accounting and defining confinement building as equipment — to make them eligible for investment credit and five year depreciation, invite investment by non farmers who can receive these benefits only by investing in agriculture.

Tax shelters encourage farms to grow and invest heavily in capital, and economically punish those who don't.

By encouraging rapid expansion on borrowed money, tax shelters encourage risk taking which has gotten many family farmers over extended and in financial trouble.

By encouraging the introduction of corporate/non farm investment and growth by established farms, tax shelters reduce opportunities for beginning farmers who are squeezed out. Beginning farmers find it difficult to compete in a tax shelter industry because they generally lack high incomes against which to use tax breaks and they lack the money to make large capital investments in land, new machinery and elaborate facilities which generate tax savings. With fewer farmers starting, the number of farms declines.

The continuation of current policies and trends will place most farm income and control of food production in very few hands, leaving little opportunity for beginning commercial farmers, with increased separation of ownership, labor and management; and a large number of small hobby farms.

Family farm meat production is particularly affected by tax policy. The cattle feeding industry has shifted out of the hands of farmer feeders into regions dominated by large commercial lots, many of which custom feed for tax motivated investors.

I understand currently[3] one half of our cattle are fed in 400 lots.

'Policies which encourage elimination of moderate sized family farms do not improve efficiency. Full economies of size can be captured at a moderate scale.

Maintaining a stable number of moderate sized family farms allows the rural economy to support more people, both in agriculture and small town business.

Tax policies should be judged in terms of where they are moving agriculture and rural communities in the long run, in relation to the type of agriculture we'd like to pass on to future generations.

With the desperate situation in rural America, I can't not mention the terrible burden we're facing from the strong dollar and the deficit that is causing the present unbearable interest rates. If we could realize the devestation this terrible military budget is putting on our whole nation and put the brakes on it, we would dramatically reduce most of the dollar shortage problems our nation faces today.

I also serve on the board of directors. of my rural electric coop. I would urge that any tax law revisions considered, continue to preserve the tax exempt status of the REAs. They are right now

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undergoing probably the most bitter attacks, in their 50 year history, by the Reagen Administration. I' and I'm sure most farm people surely want to thank you, Larry, for your very strong support in trying to preserve this most worthwhile program.

Thank you for having me express my views and I'm sure they express the sentiments of many farmers

Senator Pressler. Well, thank you. I think that is a unique combination of being a farmer and serving on a local bank board.

I found in Pierre yesterday that there are a lot of allies of the farmers. The small businessman and the bankers and many others who realize that their livelihood is directly related to farming. I think the leaders of that rally should be commended for doing a good job of coalition building, of including different groups.

We appreciate the work you have done for the REA's on the State and the national level. I just think you do a great job and we are glad that you are here.

I thank you very much.

I am next going to call on Bruce Odson from Huron who has done a great deal of work here in local business activities and banking. He is one of the most outstanding young leaders in our State, and I am glad, Bruce, that you are here.

STATEMENT OF BRUCE L. ODSON, PRESIDENT, FARMERS & MERCHANTS BANK, HURON, SD

Mr. Odson. Well, thank you very much.

We have had a few minor changes to our testimony, more grammatical errors, and we will correct those and get those submitted to the committee.

We want to express our thanks to the U.S. Senate Committee on Small Business, and specifically South Dakota's senior Senator, Larry Pressler, in providing this opportunity to testify.

We wish to address several key issues. The first series directly affects small business and their ability to generate capital. The second series of ideas more directly affects the philosophy and implementation of the flat tax.

First, the business climate of rural America is significantly different than the business climate and opportunities in the suburbs of the District of Columbia or the bedroom communities of Connecticut. Likewise, it is significantly different than the boom cities of the Sunbelt and the Pacific Northwest.

Small business in South Dakota is truly small business. The management challenge here is much more difficult than in the previous mentioned locations. In most South Dakota communities small business is much more likely to have ups and downs and changes in sales because of weather, like drought, commodity prices and the heavy proportion of people on fixed incomes.

The economic theories of the Federal Reserve Bank concerning elasticity of demand and on interest rates only indicates that their understanding of small business in rural America is minimal at best.

With those opening comments let me address specific issues. The first is itemized deductions—personal.

We support the deduction for mortgage interest on the principal personal residents. Besides savings in banks, the personal residence is the primary major segment of net worth of most wage earners in South Dakota, and since we have not had significant escalation in housing values as the previous mentioned sections of the country, this section would permit a much more rapid accumulation of capital in a community our size.

There is a statement in the material provided us stating:

> All three of the modified flat tax proposals would in some cases disallow substantial amounts of interest that can now be deducted by real estate investors who do not have sizable net investment income.

As I interpret this, the local union wage earner who buys a house down the street for rental income now and retirement income later would be penalized, while under the Bradley Gephardt and the Kemp-Kasten bill the person buying the second home in Palm Beach or Bar Harbor would not.

Second, retirement savings. We support the Treasury plan that would increase the IRA deduction limit to $2,500 for an employed individual, plus an additional $2,500 on behalf of a nonemployed spouse. Again, in a community like ours with limited income expansion, this program is key to providing capital growth.

Third, business taxes.

I am greatly disturbed by the statements that corporations with taxable income under $50,000 or less could pay twice as much in income taxes under the Treasury and the Bradley-Gephardt proposal. If there is to be any viability on Main Street America, we need a tiered system for the first $100,000 in earnings. Only Kemp-Kasten addresses this issue and they use $50,000.

Somewhere in Washington and the Federal Reserve Bank it must be recognized that Main Street businesses in Huron and the family farm and other small towns of America are not the same businesses that are the Fortune 500 companies headquartered in New Jersey, New York, and other major centers.

Fourth, other business tax provisions.

As we review the proposals, indexing to inflation becomes more important. A general comment may be that indexing to inflation changes the simplicity and just replaces all the variations we have today.

In addressing the issue of inventory, the major issue on Main Street America is the volatility of sales and, as I indicated before, it comes from a number of things, commodity prices, fixed income, weather and so forth. The situation then is created where you carry the inventory to the next year at a substantial cost. And because of the capital structure of many businesses, this is a significant cost factor and some adjustment must be made for businesses in communities our size to carry that inventory with assistance other than another emergency loan.

Since time is limited, let me address briefly the philosophy and implementation of the flat tax. We need to recognize and feel in our own mind that a change in the tax law will create jobs and capital. This needs to be the primary consideration.

The tax system needs to be contemporary and affect in a positive manner all sections of the country and not just those with high income, and my empathy is to those of you who must vote on all these changes.

My final statement is a call for a transition period. Business today is structured because of our present code. The change overnight may sound great in theory, but to the day-to-day manager it would be a nightmare.

While visiting with an associate of mine in Minnesota, Bruce Gilmore, he offered the idea of a 5-year phase-in. In closing I will explain the concept.

Each year for 5 years each person or entity would prepare two tax returns. Since the whole concept that we are discussing is simplicity, the additional time should be minimal. The first year you would pay 80 percent of your old tax liability and 20 percent of your new. In corresponding years the ratios would be 60/40, 40/60, 20/80 and then a complete phase-in.

If there is anything in this concept we are talking about, it is fairness, and this phase-in would be a key element.

To summarize three key points:

Let's make sure the change will permit the creation of capital on Main Street America.

Second, Main Street America is different than the corporate giants and we must give them an opportunity, such as a graduated tax up to the first $100,000 in earnings.

Third, let's be fair, and let's have a phasein on this program.

Senator Pressler, we want to thank you for coming to Huron and we want to thank you for the opportunity to testify.

[The prepared statement of Mr. Odson follows:]

STATEMENT BY
Bruce L. Odson, President
Farmers & Merchants Bank
P.O. Box 848
Huron, South Dakota 57350

BEFORE SUBCOMMITTEE ON SMALL BUSINESS AND FAMILY FARM
SENATE SMALL BUSINESS COMMITTEE
February 13, 1985
Huron, South Dakota

We want to express our thanks to United States Senate Committee on Small Business and specifically South Dakota's Senior Senator, Larry Pressler, in providing this opportunity to testify.

We wish to address several key issues. The first series directly affects small business and their ability to generate capital. The second series of ideas more directly affects the philosophy and implementation of the flat tax.

First, the business climate in rural America, irrespective of the current ag situation, is significantly different than business opportunities in the suburbs of the District of Columbia or the bedroom committees of Connecticut. Likewise, it is significantly different than the boom cities of the Sunbelt and Pacific Northwest.

Small Business in South Dakota is truly small business. The management challenge here is much more difficult than the previous mentioned locations. In most South Dakota communities, small business is much more susceptible to up and down changes in sales because of weather re: drought, commodity prices, and fixed incomes. The economic theories of the Federal Reserve Bank concerning elasticity of demand and on interest rates only indicate that their understanding of small business and rural America is minimal at best.

With those opening comments, let me address specific issues.

1. Itemized Deductions-Personal

We support the deduction for mortgage interest on the principal personal resident. Besides savings in banks, the personal residence is the primary major segment of net worth of most wage earners in South Dakota and since we have not had significant escalation in housing values as the previous mentioned sections of the country, this section would permit a more rapid accumulation of capital in a community our size.

There is a statement in the material provided to us stating "all three of the modified flat tax proposals would in some cases disallow substantial amounts of interest that can now be deducted by real estate investors, who do not have sizable net investment income." As I interpret this, the local union wage earner, who buys a house down the street would be penalized, while under Bradley-Gephardt and Kemp-Kasten, the person buying the second home in Palm Beach or Bar Harbour would not.

2. Retirement Savings

We support the Treasury plan that would increase the IRA deduction limit to $2,500 for an employed individual plus allow an additional $2,500 on behalf of a nonemployed spouse. Again, in a community with limited income expansion, this program is key to provide capital growth.

3. Business Taxes

I am greatly disturbed by the statements that corporations with taxable income of $50,000 or less could pay twice as much in income taxes under the Treasury and the Bradley-Gephardt proposals. The Bradley-Gephardt is especially harsh on small business. If there is to be any viability on main street America, we need a tiered system for the first $100,000 in earnings. Only Kemp-Kasten addresses this issue and they use $50,000. Somewhere in Washington and the Federal Reserve Bank, it must be recognized that the main street businesses in the Hurons and other small towns of America are not the same businesses that are Fortune 500 companies headquartered in New Jersey, New York, and other major states.

4. Other Business Tax Provisions

As we review the proposals, indexing to inflation becomes more important. A general comment may be that the indexing changes the simplicity and just replaces all the variations we have today. Addressing the issue of inventory, the major issues in main street America is the volitility of sales. Inflation is a problem, but a more important issue is the cost of carrying that inventory when a drought or someother situation neccessiates carrying that inventory to the next year at a substantial cost. And, because of the capital structure of many businesses, this has a significant cost factor. Some adjustment other than another emergency loan must be made.

Since time is limited, let me address briefly the philosophy and implementation of the flat tax.

We need to recognize and feel in our own mind that a change in the tax law will create jobs and capital. This needs to be the primary consideration. The tax system needs to be contemporary and affect in a positive manner all sections of the country not just those with high income. My empathy is to you who must actually vote on all these changes.

My final statement is a call for a transition period. Business today is structured because of our present code. To change overnight may sound great in theory, but to the day-to-day manager, it would be a nightmare.

While visiting with an associate of mine in Minnesota, Bruce Gilmore, he offered the idea of a five-year phase-in. In closing, I will explain the concept.

Each year, for five years, each person or entity would prepare two tax returns. Since the whole concept that we are discussing is simplicity, the additional time should be minimal.

The first year you would pay 80% of your old tax liability and 20% of your new. In corresponding years, the ratios would be 60/40; 40/60; 20/80 and then a complete phase-in.

If anywhere in this concept we are talking about fairness, this phase-in would be a key element.

To summarize three key points:

1. Make sure the change will permit the creation of capital on main street America.
2. Main street America is different than the corporate giants. We must give them an opportunity such as a graduated tax up to the first $100,000 in earnings.
3. Let's be fair; let's have a phase-in on this program.

Senator Pressler, thank you for coming to Huron, thank you for permitting me to testify.

Senator **Pressler**. Thank you very much, and I am going to have a question or two on the IRA and how we can get more of that money to stay in South Dakota in some of our banks here.

Hal, let me call on you next, and let me thank you for your leadership in the chamber. We have enjoyed working closely with you and we look forward to working with you more.

So at this time we will call on Hal Bisch.

STATEMENT OF HAROLD J. BISCH, PRESIDENT, HURON AREA CHAMBER OF COMMERCE, HURON, SD

Mr. **Bisch**. Thank you, Senator Pressler, members of the panel and audience.

I also am certainly far from a tax expert and not operating a business but rather representing businesses. I feel probably even a bit more further removed.

However, as president of the Huron Area Chamber of Commerce of South Dakota, I represent approximately 300 small businesses as well as a few medium sized businesses and a few large businesses as well as many farmers.

With Huron being a farming community with a high percentage of its urban business being agri business, our tax concerns are mostly those that affect the farmer and the small business person as well as individuals.

Huron is a community with many retired and near retired people. So our concerns also are for those people who have counted on their retirement as it relates to the tax laws that are in effect today. These are people who have worked hard all their lives to build assets whether it is their farm equity, business ownership or stocks, bonds and other income property to enable them to carry out their retirement dreams of travel or going south for the winter or just living the lifestyle that they have planned for.

We need to be careful that the proposed tax proposals protect these concerns. We are well aware that deficit spending must be reduced and that the Federal Government must work within the framework of a balanced budget.

We raise the question do we now have an overwhelming tax burden? We look at the tax rate proposals, Treasury, Bradley-Gephardt and Kemp-Kasten, and as we understand these proposals we see areas where small businesses and lower income individuals will see an increase in their taxes in some cases.

We see so many changes in the tax laws from year to year, such as 1985 regulations for business use of automobiles that it makes it difficult and impractical to operate to the rules set up by the Internal Revenue Service. It appears that there is more effort being put into squeezing out an extra dime in the tax route than there is in working for the economy in the bureaucracy.

I am concerned about the proposed repeal of the long-term capital gains tax for individuals and corporations. We see this as possibly increased taxes for business individuals and retirees.

Regarding proposals to disallow tax exempt industrial development bonds while, as has been pointed out earlier, this is certainly an area that will attract and help to attract business into our sized community. We see this also as perhaps slowing some business expansion. However, as proposed, it would no longer be a consideration for anyone. We would expect business will continue to expand when its assets and credit will allow it to expand on a sound business basis.

Regarding taxing for international provisions, we feel that special tax status for foreign sales corporations should be taxed high enough to allow similar American sales to be able to compete so that our industries, all things being equal, will not be subject to unfair competition caused by foreign government's support of their companies and their products. There are other concerns such as competition caused by the value of the dollar in the foreign market such as we have today.

Fringe benefits, we are opposed to taxation of fringe benefits. Let's let the free enterprise system operate at least in this highly expensive area for business and industry to provide for their people who might otherwise become a burden on society.

We are sure that private enterprise will handle these areas of social responsibility at considerably less expense to everyone than the Federal Government could even attempt to do.

Regarding credits and deductions, the repeal of the investment tax credit could tend to reduce expansion in plant and equipment, and we are certainly looking for expansion in those areas in this part of the country.

We don't quarrel too much with elimination of the accelerated cost recovery system.

Regarding accounting of inventories we would support the last-in/first-out system being retained as it is.

If the tax laws are changed, the support of the free enterprise system must be emphasized and thorough studies should be made to not further burden the small businesses and lower to middle income individuals, and that the real need must be in reducing the size and cost of Government.

Senator Pressler, that concludes my statement.

[The prepared statement of Mr. Bisch follows:]

The Heart of Eastern South Dakota
Huron

HURON AREA CHAMBER OF COMMERCE
15 FOURTH ST., S.W. — HURON, SOUTH DAKOTA 57350
TELEPHONE (605) 352-8775

Re: U.S. Small Business Committee Field Hearing on impact of tax reform proposals on the small business economy, February 13, 1985, Huron, South Dakota

STATEMENT

1. Harold J. Bisch
2. President of the Huron Area Chamber of Commerce
3. 15 Fourth St. SW, Huron, South Dakota
4. Subcommittee of U.S. Senate Small Business Committee conducted by Senator Larry Pressler
5. February 13, 1985, Huron College

As President of the Huron Area Chamber of Commerce of South Dakota, I represent approximately 300 small businesses as well as a few medium and a couple of fairly large businesses, as well as many farmers.

With Huron being a farming community with a high percentage of it's urban business being agri-business, our tax concerns are mostly those that affect the farmer and the small business person as well as individuals. Huron is a community with many retired and near retired people, so our concerns are also for those people who have counted on their retirement as it relates to the tax laws that are in effect today. These are people who have worked hard all of their lives to build assets, whether it's their farm equity, business ownership, or stocks and other income property to enable them to carry out their retirement dreams of travel, go south for the winter, or just live in the life style they have planned for. We need to be careful that the proposed tax proposals protect these concerns.

We are well aware that deficit spending must be reduced and that the Federal Government must work in the framework of a balanced budget.

We raise the question, do we now have an overwhelming tax burden? We look at the tax rates proposals: Treasury, Bradley-Gephart, Kemp-Kasten, and as we understand these proposals, we see areas where small businesses and lower income individuals will see an increase in their taxes.

We see so many changes in tax laws from year to year, such as 1985 regulations for business use of automobiles that make it difficult and impratical to operate to the rules set up by the IRS. It appears that there is more effort being put into trying to squeeze out an extra dime in the tax route than there is in working for economy in the bureaucracy.

FIVE YEARS
ACCREDITED
CHAMBER OF COMMERCE
CHAMBER OF COMMERCE OF THE UNITED STATES

I am concerned about the proposed repeal of the (long-term) capitol gains tax for individuals and corporations, we see this as increased taxes for business, individuals, and retirees.

Regarding proposals to disallow Tax-exempt IDB's, we see this as perhaps slowing some buisness expansion; however, as proposed it would no longer be a consideration for anyone. We would expect business will continue to expand when it's assets and credit will allow it to expand on a sound business basis.

Regarding taxing for International Provisions, we feel that special tax status for foreign sales corporations should be taxed high enough to allow similar American sales to be able to compete so that our industries, all things being equal, will not be subjected to unfair competition caused by foreign government's support of their products and companies. There are other concerns such as competition caused by the value of the dollar in the foreign market etc.

Fringe Benefits. We are opposed to taxation of Fringe Benefits. Let's let free enterprise operate at least in this highly expensive area for business and industry to provide for their people who might otherwise become a burden on society. We are sure that private enterprise will handle these areas of social responsibility at considerably less expense to everyone than the Federal Government could even attempt to do.

Credits and Deductions. The repeal of the investment tax credit would tend to reduce expansion in plant and equipment.

We don't quarrel too much with the elimination of the Accelerated Cost Recovery System.

Regarding Accounting of Inventories, we would support LIFO system being retained as it is.

If the tax laws are changed, the support of the free enterprise system must be emphasized and thorough studies should be made to not further burden the small business and lower to middle income individuals and that the real need must be in reducing size and cost of government.

Sincerely,

Harold J. (Hal) Bisch, President
Huron Area Chamber of Commerce

Senator Pressler. Thank you very much, Hal.

Let me say, first of all, that the problems caused by the deficit are very much on my mind. I think part of our farmers' problems is the high interest rates which I attribute to the deficit, although Jack Kemp is starting to argue with that a little bit.

I personally believe that competition for money is what causes interest rates to be high. I think if we could get the deficit down it would help us a great deal. So I appreciate your statement.

Let me say that I am a cosponsor of an across-the-board freeze, and that makes all groups in America unhappy, but I think it is the best approach. I think we have to treat military spending as we treat the other categories, and I think we should treat agriculture as we treat the other categories. Right now the weaker constituencies are treated worse than what I consider to be the stronger ones.

But, in any event, I want to take the opportunity just to ask some questions here because I was fascinated with certain things, and then I am going to call upon staff to ask questions.

Joe, let me ask you. You gave a fine speech on the problem of tax shelters in drawing money into agriculture and driving out the real farmers. And I am cosponsoring with Senator Abdnor and others legislation that would make it much more difficult to let's say write off farm losses by total nonfarm people.

The trouble with writing such legislation is you get into a sticky wicket when you get to these tax policies. The general statement is always good, but then you find the exception.

For example, we have a lot of South Dakota farmers who have to work in town to make a living. This is fellow who is working in a meat plant or working any place supplementing farm income and would not be able to deduct farm losses from nonfarm income. How do we make a distinction there? Do you see what I am saying?

Mr. **Matthews**. Yes, I do, but it should have been something easier. Well, I obviously don't have the answers to a lot of the things that I am proposing, but I have some strong feelings on them. I know what you are saying. We have a farm full time and we have got neighbors that have worked in town for years and that is certainly an essential part of our whole State now. I don't want to take that away.

But I guess I am thinking more of the aspects of cattle feeding, that is our biggest thing, and the unfair competition that we are facing from people that, you know, are feeding tens of thousands and hundreds of thousands. Like I say, 400 lots feed the Nation. I don't say that we want to go back to 25 head per farm. Well, we haven't got enough farms to do it any more.

But there has to be some special considerations for the people that can afford to take a loss for a while or the shifting of the cash versus accrual accounting where it is so easy to shift expenses in that manner, and some of these things are what I think have to be addressed.

I know there are no easy answers. Your concern for the person working in town is well justified and I am just as concerned. I guess I can't answer you directly how I propose that, but I think you hear what I am saying.

Senator **Pressler**. I certainly do, and you hired me to figure it out. [Laughter.]

That's good. No, I appreciate that very much.

Bruce, I wanted to ask you about the spousal IRA's, the individual retirement account, and now there is a $2,000 IRA allowed for each individual taxpayer who works, as I understand it. I know that a lot of farmers feel that their wife works on the farm even though they are not incorporated so she is not paid a salary. There are many housewives who help out in small business and there is a great deal of savings done through IRA's. As a matter of fact, I think it is one of the few good savings programs we have had in this country which saves less than six other industrialized democracies.

But let me ask you two parts. I think you mentioned $2,500 as the IRA proposed level. Why would you propose a spousal IRA?

Mr. ODSON. Well, let me address a side issue related to that real quick. You know, we hear everything on equal rights. I think in the small businesses and family farms of America that women have played an equal part for a long time and will continue to do so.

On the IRA question, it is a means—you know, we just talked about tax shelters and there aren't a whole lot of good old normal tax shelters out there, and the IRA I guess is one of them. To take a family farm or a family business on Main Street, it is pretty hard to differentiate that, you know, it earned so much money and the husband earned this and the wife earned this and so forth, and I am sure in some households you may have your own debate.

But there is an equal part there and it provides an additional capital accumulation in rural America. It is one thing that is working. People can put it in, defer the interest to later, and I would like to look at two additional equivalencies of IRA's, one possibly for education and the other possibly for medical expenses. Those two areas are changing dramatically.

We just feel there is parity in the contributions of what those people are doing in the livelihood of the family unit and it should be even.

Senator PRESSLER. OK. Now the other point that you make is that it is key to capital growth. Can we keep some of that IRA money in South Dakota or do people have to invest in mutual funds outside? Can they come into your banks, small banks so that the IRA money stays here?

Mr. ODSON. We would be happy to take care of everyone. There are two aspects I guess related to that. In a particular economy of which we are in, and we are in a critical situation, the fact that that interest is compounded and deferred permits capital formation. So we have more dollars to lend out. Whereas, if it wasn't deferred it could be taken out for operating expenses, a catch-22, but it is compounded and produces new capital for us because of the deferral aspect.

I am not sure, and I was giving thought to how we address the issue of if somebody buys their IRA with Fidelity Mutual Funds in Philadelphia how do we get those dollars back to us. Again, we may get away from the concept of taxable vacation by giving us some type of tax credit mechanism to reinvest those dollars in South Dakota. At the moment it is one of the few growth vehicles of deposit generation we have, which is very good. How we change it so we get a better benefit than Fidelity Mutual Funds at this time I can't answer.

Senator Pressler. This just occurred to me sitting here this afternoon. Would there be a way for small banks or financial institutions to rather than just passing on the money, hold on to it and reinvest in their community?

Just as small banks can have Federal Deposit Insurance Corporation guaranteed deposits up to a certain amount, it would seem that there would be a vehicle, by which we could keep the money in this area. Of course, maybe the returns on the type of investments available here are not high enough at this time. Certainly I suppose agriculture would be one example and the return wouldn't probably be high enough and that the capital would go to some other area.

Mr. Matthews. Yes.

Senator Pressler. You can, and where does it go, do you know?

Mr. Matthews. Well, it stays local if you keep it in capital of course. I don't think we have the available funds. We have it available, but I don't think we have the fund options available. If it is deposited there, you have got it.

Senator Pressler. So it helps build up your deposits in that sense.

Mr. Matthews. It sure does.

Senator Pressler. Now Senator Dole has been concerned about the loss of revenue from having the spousal IRA, but the loss of revenue would be much greater if we increased the exemption to $2,000. I think IRA's are one of the few things that rewards savers and it is something that I have supported and would support because I think in the long run people might need it considering the solvency of some other programs that they might be depending upon.

Let me take the opportunity to ask the mayor, and he didn't bring this up, but it was brought up later on, regarding industrial bonds, revenue bonds and a lot of State bonds and county bonds are tax free and there is a lot of economic activity that is not therefore taxed by the Federal Government. The Federal Government has a $200-billion deficit and many States have surpluses because they have been much more careful, but also a lot of State budgets are close to 50 percent Federal funds.

Should we continue the tax-free treatment of State and municipal bonds? I know the testimony from the chamber is very much against this and many of our communities depend on it. It would be a real blow to have it turned off immediately, but in the long run should we have a phaseout program or should we keep it? What is your view?

Mayor Flanagan. Well, I did, Senator, make reference to a personal position on the tax deductibility, dividend deductibility continuing on the IDR bonds issued by local entities. I am sure I made reference to that in my statement.

Senator Pressler. Yes. I am sorry. I am mixing up statements.

Mayor Flanagan. And I couldn't I guess say it much better than I did there. For a variety of reasons that everybody here is probably familiar with, we just don't attract the kind of investment that the metropolitan areas do. One of the few ways that we have of getting some of those investment dollars here for major developments is the fact that the interest earned on that type of bond is a tax deductible item, and I definitely support, as does the Huron City Commission and I am sure the chamber board, the indefinite continuation of that item.

Senator PRESSLER. Also you mention in your statement, and now I have got the right one in front of me, about indexing, and that you believe indexing should be discarded as unworkable.

We do have the indexing concept, I think it is written into law to phase in. Of course with the inflation moving at a little slower level that probably won't be quite as drastic.

Do you think there are any types of indexing that should be preserved or do you think if we just did away with it we would be better off?

Mayor FLANAGAN. Well, the tax preparers and CPA's that I visited with this past week on the subject, not one of them, and I visited with several, had anything good to say about it. And certainly it was way beyond me to understand, not being a tax expert personally, how the thing could work, and my concern is that if those people whose full time profession is devoted to understanding the rules of tax preparation, if they have concerns about indexing, there has got to be legitimate concerns.

Senator PRESSLER. Well, I think that is very true. And I very much appreciated the first part of your statement where you said that by passing a tax bill every year we really cause a lot of confusion and expense. I am told that the first major revision of the code was in 1954, and it was pretty much left that way until 1969 or thereabouts. Then it was revised in 1974 and we had a major tax bill 3 of the last 4 years. In fact, the IRS is behind in implementing the regulations which are required by these tax bills and it really has created confusion.

So unless we are going to do something that really does some good, it is Senator Packwood's view, at least, that we should leave it alone for a while. And many of the proposed plans, the Treasury plan and the Kemp-Kasten and the Bradley-Gephardt all have so many variations in them that we are almost back to the same thing. I can just see one of the amendments moving through the Senate Finance Committee and the House Ways and Means Committee and the full Senate and House, getting bogged down with a Christmas tree of amendments and suddenly we are right back where we started. So I think the opening part of your statement is something that I picked up several times today.

Let me ask Tom if you have some questions.

Mr. WALSH. I have one question of Mayor Flanagan. One of the arguments against allowing tax deduction for the interest on industrial revenue bonds is that the next result is you just have communities competing against each other offering industrial revenue bonds to potential industry and the result is a wash.

Can you comment on that from your experience?

Mayor FLANAGAN. How do you mean results in a wash?

Mr. WALSH. That in terms of competing with another community you would be offering the same benefit, and therefore as far as the potential employer is concerned it makes no difference where he goes.

Mayor **Flanagan**. Well, there is some logic to that I guess. There is some realism to that in terms of Huron competing with Aberdeen, Brookings, Pierre, and one of the South Dakota cities, but we don't have any problem with that. It may be a wash in that area, but one of us is going to get it. And the organization that we are dealing with typically, that opportunity of the IDR may be the thing that brings it to South Dakota in the first place.

They recognize the productivity of our people and the loyalty of our people and the trainability and our no corporate income tax and the low worker's compensation rates, and they also recognize our climate isn't exactly what their wives might want. But they can sell themselves because of all those other things and maybe balance off the advantages of being closer to the marketplace, living in metropolitan areas and the better climates of the South or something like that.

So we came down to an IDR deductibility of dividends as being a key element in getting them here. And, sure, once they get their mind made up that South Dakota is where they want to be, then we have got the competitive situation and it could be a wash then in terms of one community or another, but at least we got them to look at South Dakota and to locate in one of our communities that we might not otherwise have been able to do.

Mr. **Walsh**. One of comments that we have heard very frequently is yours that the Tax Code has changed so much that people can't possibly understand it. Do you think it is really not so much a matter of simplifying the Tax Code as making it stable so that people can catch up and understand it. The Tax Code could be understood if people just had the opportunity to know what it was.

Mayor **Flanagan**. Well, stabilizing it of course would make it easier for our practitioners, our professionals to get caught up. I am not sure that stabilizing it that for most of us we would ever catch up.

But to go back to the 1954 Code when most of the people in this room that were filing income taxes at that time probably were able to do it on their own. I think the Senator referred to 1969 as the next major revision. I think at that point almost everybody started having a professional do it. We may not ever get back, and maybe we don't really want to. I am sure from the professional's point of view they hope we don't go quite a bit, that far back where any of us could do it ourselves. But certainly stabilizing it might let those professionals catch up in determining the impact of what we have already drafted and haven't implemented is going to do.

Mr. **Walsh**. Mr. Matthews, you talked about the people with tax shelters running up the price of land and competing with you. Do you know to what extent those tax shelters are dependent on the accelerated depreciation and the investment tax credit?

Mr. **Matthews**. Well certainly today the situation that exists on the farm right now, investment tax credit, for instance, has been helpful to many farms, and our farm it has many times. But the point that I am trying to make on that is that, you know, we think that it helped us quite a bit, if we get a few thousand dollars tax credit, and that is helpful.

But now our problem is to make enough money so that we can use that up and not lose it. And the scale of size dictates, particularly in some of the large confinement things that I don't know if you are familiar with that are taking over in the cattle feeding and hog production, too, now in the Midwest. They are huge in size and scope, and tax shelters, investment tax credit and fast depreciation are some of the things that are making it possible. I am pretty sure of that.

Mr. **Walsh**. One other thing I think I understood you to say was that partially because of the availability of the accelerated depreciation and the investment tax credit, some farmers got overextended. Is that right?

Mr. **Matthews**. Well, this certainly is a possibility. Here is a corporation that is established next to you, a big one, and they are doing these things and, you know, if you wanted to expand just a little bit, you didn't have to try to take on the whole township. But the prices we were paying for our products and now where we are at, the prices we were receiving, why that is what caused the bind, as I see it, and it probably did help to cause some of the problems on the farm right now. We can't blame anybody for it, but it is one of those things of how it did get out of focus of the true natural course that business evolve.

Mr. **Walsh**. Thank you.

Mr. Odson, one objection that people have raised to this spousal IRA is the claim that that will just benefit essentially wealthy taxpayers. Could you respond to that?

Mr. **Odson**. Compared to a lot of the other provisions within the bill here, this is more for the average wage earner than any other tax shelter that you have.

The primary person putting their money in an IRA today is somebody probably 45 and over with a demonstrated ability to save and has what you call your average income. The person in the high income bracket is going to put money into it, but they are going to be in all the other tax shelters that Joe already mentioned.

Mr. **Walsh**. Thank you.

Senator **Pressler**. I might just ask a final question here, and that is if we repeal the current investment tax credit which allows for substantial reduction in the initial cost of the investment in depreciable property, if we just repealed it across the board, which all three proposals up here envisage, I am trying to figure out what impact that would have actually on investment, if people would buy less new equipment or if they would buy the same amount?

Would any of you like to make a judgment on that and also how it would affect the sale of farm machinery?

Mr. **Odson**. Well, at the moment anything that might adversely affect what sales of farm machinery is that is left we wouldn't look at in too positive a light. I guess it depends on the case of the financial condition that the individual. If they use the tax credit, it may be the stimulus to make that activity go and make it cost-justifiable. If they are in a position where they can't use the investment tax credit, then I think it becomes a moot issue. But it still can have a critical element unless the other provisions would make up for that.

I probably would like to see something stay in predicated either on economic conditions or certain economic groups.

Senator **Pressler**. Do you have any feel for that?

Mr. **Matthews**. Well, I think it has had its place in a beneficial way to the farms. It certainly has on our farm many times. But I think right now what I am looking at, and I am pretty good friends with our local John Deere dealer and have known him for years. He tells at yearend this year he made a couple of sales that were based on that and I don't want to chase those away because they are having a hard time just like we are and I am well aware of that.

But the thing that it is really adversely affecting is the way the cattle feeding and hog feeding is going in that it is a great thing for those things, like the one in Iowa. Five of them in the Nation are now in the process, and the one in Iowa is going to produce 600,000 hogs in a year, and those 5 in itself it is calculated from figures that I have seen could have the effect of reducing hog prices by $2 for the whole Nation. You know, it is devastating what it is going to do to us individually, but I am sure there are farms that the tax credit has been beneficial for even this year, people that were older and established and didn't have any interest bill or mortgage payments.

Senator **Pressler**. Hal, do you have any comments on the investment tax credit issue?

Mr. **Bisch**. I guess I just think it will probably slow business down, investment.

Senator **Pressler**. There are a number of other questions regarding the preferential treatment of capital gains and the different kinds of depreciable property, including in some instances farm property and what the useful life should be. Usually those things are determined administratively, but we find ourselves sometimes writing letters trying to effect it.

Let me also say that we are running a little short on time, but I think this panel has presented a lot of good ideas, one of which is on the IRA. Certainly if we could find a vehicle to keep them regional or local, it would be very much an improvement.

I think your testimony is going to be very helpful and I will take it back to Washington. Also we will present it to the Finance Committee, and we thank you very much.

I will call all the rest of the witnesses up together if I can get a list of them here because I know they have been waiting a long time and I feel badly about that.

Why don't we have Bob Ingle; Lloyd Beckman, whose "D" John Deere I have driven; William Anderson; and Joe Statz come forward.

Joe Statz, State Snyder Drugs; William Anderson, president of Anderson's Furniture, Inc.; Lloyd Beckman, a farm implement dealer from Brookings; and Bob Ingle.

It doesn't matter if you have a statement or not. You can give your views.

Thank you very much for being here, gentlemen, and thank you for waiting so long.

Perhaps I can call on Lloyd Beckman from Brookings first. You can give us a report on the "D" if you wish. [Laughter.]

STATEMENT OF LLOYD BECKMAN, BROOKINGS, SD

Mr. **Beckman**. It is still there, Larry.

Senator **Pressler**. Good. It is a "D" John Deere that I sometimes used to drive in parades. I am getting kind of old for that, but anyway I really enjoyed it. Nice to see you, Lloyd.

Mr. **Beckman**. I want to thank you, Larry, for the opportunity to testify here today.

It is encouraging to see the Federal Government trying to simplify the present tax structure. However, in view of past experience, I am somewhat skeptical.

I think this past law, or the one they have just passed in 1984 is an example of how the Federal Government is trying to simplify our tax laws, and it makes it pretty tough to live with .

I believe that any one of the so-called flat tax proposals would be an improvement over the present tax laws. However, of the three, I think that the Kemp-Kasten bill would be better than the other two for the following reasons.

The maximum tax rate on the Kemp-Kasten bill is lower by 5 to 10 percent than the other two, at least the way I understand it.

I don't think that the Government, and by this I mean all government, I mean the Federal Government and the local government and the State government should ever take more than a third of anybody's income. I mean corporations, personal or anybody else. I think to do that just depresses the incentive to produce.

I think the Government has recognized in the past that the tax rates have been way too high, and for this reason we have got all these different tax incentives. The Government is tinkering with all the tax laws trying to stimulate one section of the economy or the other, and I believe if they would lower the tax rates and let the people produce the way they thought they could make a living or make an income it would be better.

I am glad to see that two of the proposals, while repealing the capital gains tax, make an allowance for gains due to inflation. It is hard for me to see where there is any justification for a tax on a capital gains. Say, for instance, a farmer that bought a quarter of land 10 years ago or a home owner that brought a house 10 years ago and they sell it today and say that the price is double. What justification is there for any capital gains tax on that sort of a gain. It is no different. Its value is just exactly what it was 10 years ago. One quarter of land is one quarter of land today. A house is the same house it was but maybe has depreciated some over the years.

Those are the types of gains that I don't think they should tax at all. If somebody buys land and changes the purpose of it, say he buys land next to a city and puts in a housing development, this is different. They are changing the purpose of that property and that is a business investment and could be taxed.

I noticed that all the proposals are for repealing the investment tax credit, and probably the people here today, it would affect us more directly. We are in the farm equipment business, and over the past years I am sure that has stimulated our sales. However, I don't think that is the kind of laws that I would like to see. I don't really see the justification for it.

If a customer of ours or if we ourselves in making our decisions on what we are going to purchase, if we can't justify the cost of an item, I don't think we should be doing it because we are getting a rebate from the Government or whatever to stimulate our buying. And I know if it was repealed it would probably hurt our business, and for that reason it would also hurt our customers. I think that maybe it could be repealed over a number of years.

I think if we are going to want a simplification of the tax laws, we are going to have to look at doing away with some of these incentives that help us financially, too. And I just don't think that is the kind of laws that we need providing the tax rates are low enough so that we can make a profit on what we buy, and if the machinery that we sell, if it will justify itself in what it will produce. I think those are the things that should influence the decision.

I appreciate all the efforts to simplify our tax laws, but I think there are some philosophical matters relating to our taxes in this country that have to be addressed first, and I don't think new tax laws are going to do any good unless we do.

I think that Congress has got to operate on the same set of laws and values that they expect the people to, and I am not referring to you, Larry. I think you have done a good job for us. But I do think that there have been times when Congress has passed laws to benefit themselves in a way that they wouldn't allow other citizens to benefit.

But the big item that is hanging over everything, and that is our deficit. It is just almost impossible to believe that in the times like we have, and we have hard times in South Dakota now, no question. But the economy of the country is pretty good. And to think that our Federal Government is operating with deficits in the realm of $200 billion a year, that just staggers the imagination.

And that isn't all of it. From what I read you look at the future commitments of the Social Security system, the pensions that the Government is liable for for the military personnel and for the Government employees, unless somehow we can come to grips and do something about that deficit, it is going to destroy the Government and no tax law that we talk about is going to do any good.

And I think nobody is going to want to pay taxes unless they can see that somehow we can support the Government, and the way it is now I don't think any taxes that we pay are really going to make much difference unless something is done about the deficit.

Thank you, Larry, for the opportunity. There is much I don't know about the tax laws.

[The prepared statement of Mr. Beckman follows:]

EUGENE BECKMAN & SONS
John Deere Farm Equipment
Phone 693-3514
Ag Plaza—P.O. Drawer 148
BROOKINGS, SOUTH DAKOTA 57006

Statement by
Lloyd Beckman, President of Eugene Beckman & Sons, Inc.
Ag Plaza, Brookings, S. Dak.
Before Senate Committee on Small Business
February 13, 1985

It is encouraging to see the Federal Government trying to simplify the present tax structure. In view of past experience, however, I am somewhat skeptical that the Federal Government can simplify anything.

I believe that any one of the so called Flat Tax Proposals would be an improvement over the present tax laws. However, of the three proposals I think that the Kemp-Kasten Bill would be much better than the other two for the following reasons.

The maximum tax rate on the Kemp-Kasten Bill is lower by 5 to 10 percent compared to the other two. I do not think that the government, and by this I mean Federal, State, and Local, should ever take more than 1/3 of any ones income. If they take more they just destroy the incentive to produce. The government has recognized this since they have past a multitude of tax incentives that would not have been needed if the tax rates had not been so high.

I am glad to see that two of the proposals while repealing the capital gains tax make an allowance for gains due to inflation. I do not think anyone should have to pay tax on the gain on property that is due to inflation.

I notice that all three proposals repeal the Investment Tax Credit. I agree with this approach even though it would have a negative effect on our business, at least for the first few years. I do not think this type of tax incentives should determine the buying decisions of our customers or even of ourselves. However maybe it would be less of a shock if it were phased out over a period of a few years.

I appreciate any effort to simplify our tax laws and especially to instute a flat tax. I would certainly support the Kemp-Kasten Bill. However there is one aspect to taxation that must be corrected before any new tax law will do much good. I am refering to the integrety of

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of the government. When Congress seems to operate on a different set of standards than they expect from the citizens, they can not expect anyone to cooperate with any tax laws. Also until the Federal Government, both Congress and the Administration, will come to grips and do something about the deficit, no amount of taxes collected will do much good. It is beyond comprehension that our country must operate with the yearly deficits that we have. Even worse than the budget deficits are the liabilities of the government with regard to future social security, government and military pension payments. If something is not done very soon about these deficits, no tax law will do any good. The present government could very easily collapse under the weight of the deficit.

Senator **Pressler**. Well, you know quite a bit, and I appreciate what you said about the investment tax credit. When Congress passes something like this supposedly it helps everybody, but there is a great loss of revenue. Of course some people don't have any income to take advantage of it. You have got to assume that you have an income to take advantage of it and some farmers have told me that they are not able to do that.

In any event, let's move along and hear from Bill Anderson, president of Anderson Furniture.

STATEMENT OF WILLIAM P. ANDERSON, PRESIDENT, ANDERSON FURNITURE, INC., HURON, SD

Mr. **Anderson**. Thank you, Senator Pressler.

I, too, want to thank you for this opportunity to testify on this tremendously important issue for all of us.

It is with great difficulty that someone such as myself, however, who has limited knowledge of the total scope of the tax laws answers the questions of tax reform which obviously is facing this Nation.

The masses have clamored for equity, for the closing of the loopholes and for simplification of the entire process. This is an overwhelming task for even the most advanced student of economics, to say nothing of the average small businessman such as myself.

I will try, however, to give you what I see from my position as a small rural businessman from the Midwest. Due to time limitations I will not cover all areas of my written testimony.

I would first like to address the area of personal income taxes. Although I have no particular problem with simplifying and flatening of the tax rate schedule, it is impossible to give thumbs up or down until such time that the entire picture is in place and focused.

Mayor Flanagan and I apparently have talked to the same accounting people, and references to indexing in both the Treasury plan and the Kemp-Kasten plan seem to sound inequitable before we even get started.

Indexing is as a rule difficult to apply in reality due to the inconsistent application of procedures by the general public. In a time when the vast majority are asking for simplification, why muddy the waters with difficult procedures which have been shown in many applications to be inherently unfair.

The Treasury plan calls for preventing of income shift from parents to children under the supposition that these shifts are strictly for tax advantages. Let's not lose sight of the fact that many of these shifts, as they are called, are used as college funds and are very important to the continuing education and the growth of individuals so that their incomes can be better through the education and correspondingly higher taxes of those because of the higher incomes.

The elimination of various items, such as deductions for married couples, child care credits, income averaging and alternative minimum taxes may hurt some individuals, depending on how they fall into the overall picture. I don't think we need to become alarmed about the elimination of some of these personal perks until we have a final look at the new tax packages in whatever form they develop.

Let me address now the long-term capital gains and losses.

There seems to be uniformity in all of the proposals. From a strictly personal posture I feel that there would be less enthusiasm to purchase real property from the investment standpoint since part of the advantage of doing so could be wiped out. But more significantly, that risk taking in the high tech areas, which we need so badly, would be severely curtailed. New companies mean new jobs and correspondingly tax dollars from profits and personal incomes.

I will now address the itemized deductions—personal.

The Treasury plan seems to be hung up with this indexing, as we have discussed earlier, as a way of life. Since we are not speaking of business at this moment, we are looking at a large group of individual taxpayers, many who try to do their own tax work, and indexing may very well make it impossible for an unqualified individual to handle this tax. Why do we insist on making things more difficult when simplification is the order of the day?

The Kemp-Kasten proposal would have some adverse effects on consumer spending.

In the Treasury plan I am extremely opposed to the elimination of the charitable deduction in any way. Here is a voluntary system of raising moneys for a multitude of various organizations who perform many of the benevolent duties, and by eliminating there deductions for charitable deductions by necessity it may force some of those things into the Government sector, more Government. We don't need that at this point. It makes no sense to move it from one hand to the other. We are not simplifying it.

In regard to the tax-free income proposal or elimination, all three proposals eliminate the tax exemption for income from State and local bond issues for private use. This could be devastating to small communities, as we have discussed earlier.

In South Dakota we use this form of financing to attract new industry to the communities, new industries, new jobs, and new tax moneys. And I think we also have to look at not only are we trying to attract from other locations, but how about the expansions of local businesses. I think that is one thing we are not looking at.

Another cut which seems unfair to any employee is the taxing of educational expenses relating to jobs. It seems that we again see counterproductive moves by the writers of these proposals. Better educated employees command more salary dollars which should, if the new tax bills are done with equity in mind, produce more tax dollars or more income for the Government.

Retirement savings. This section is a banking/investment/personal area which I will forego making any comments on except that we need to encourage private retirement funds in order to take the pressure off the Social Security System.

I will address tax credits.

We have all enjoyed one or many of the tax credits, whether it be personally or through our businesses. Tax credits are at least partially Government's way of controlling a sector of the economy. This was done through jobs credits, energy credits, rehabilitation credits, et cetera. This may be an area where lobbyists will really put the pressure on for their own special interest group.

Whether elimination of the tax credit will adversely affect the small business sector in South Dakota or how much it will, will depend on the overall package that comes out in the end, business taxes.

It appears that the smaller corporations can get ready to grit their teeth with two of these proposals since the Treasury and the BG plans have eliminated the lower corporate tax brackets.

Under the Treasury plan dividends will be tax deductible which will encourage their payment. The nondeductibility of corporate dividends over the years has encouraged the growth of many corporations to the level we see today. We again seem to be losing sight of that progressive and aggressive nature that we need in the business sector to continue expansion of our economic base.

A new tax system should not pull business into a status quo method of continuing, but rather should on the contrary encourage new growth through equitable and fair tax policies.

DEPRECIATION

The Treasury plan changes the present ACRS to a real cost recovery system which would have seven classes of property with varying deduction for each and, of course, we must have indexing.

We have now taken a fairly difficult system and tripled its complexity. It seems to me that we have missed the object of our charge. In addition to the difficulty in administration of these proposals, small businesses who many times depend heavily on depreciation expenses for survival, may very well be hit the hardest with these changes.

I will jump to retirement plan provisions. I do not have the knowledge to comment in detail about this section, but I would again like to encourage the writers of these proposals to expand tax legislation to enable broader participation in private retirement plans.

By encouraging private and corporate plans future generations may not need to rely on the Social Security system which more than likely will be unable to take care of their needs anyway.

In a quick summary, although all of the proposals here have some merit and some disadvantages, it seems that the underlying reasons for these changes may have been ignored or forgotten by the writers of them, a reasonable set of income tax laws which are equitable, easy to understand and progressive to our economy.

Fair tax and legislation is only a part of the total concept which must be adopted. Budget deficits may very well be crucial to the success of any tax change. American's businesses and its citizens will not tolerate unbalanced budgets being financed by inequitable taxation. Thank you.

[The prepared statement of Mr. Anderson follows:]

STATEMENT BY:
WILLIAM P. ANDERSON, PRESIDENT, ANDERSON FURNITURE, INC.
232 3rd ST.S.W., HURON, S.D. 57350

TESTIMONY BEFORE SENATE SUBCOMMITTEE ON TAX REFORM, FEBRUARY 13, 1985.

OPENING REMARKS - SCOPE OF TESTIMONY

It is with great difficulty that someone such as myself, who has limited knowledge of the total scope of the tax laws, answers the questions of tax reform which obviously is facing this nation. The masses have clambored for equity, for the closing of the "loopholes", and for simplification of the entire process. This is an overwhelming task for even the most advanced student of economics, to say nothing of the average small businessman such as myself.

I will try, however, to give what I see from my position as a small rural businessman from the Midwest. I do this with some help and direction from personal accounting and tax advisors.

I. PERSONAL INCOME TAXES

Although I have no particular problem with simplifying and flattening of the tax rate schedule, it is impossible to give thumbs up or down until such time that the entire picture is in place and focused. From an accounting standpoint, references to indexing in both the Treasury Plan and the Kemp-Kasten Plan seem to sound inequitable before we even get started. Indexing is, as a rule, difficult to apply in reality due to the inconsistant application of procedures by the general public. In a time when a vast majority are asking for simplification, why muddy the waters with difficult procedures which have been shown in many applications to be inherentely unfair.

The Treasury Plan calls for preventing of income shift from parents to children under the supposition that these shifts are strictly for tax advantages. Let's not lose sight of the fact that many of these "shifts" are used as college funds.

The elimination of various items such as deduction for married couples, child care credit, income averaging, alternative minimum tax, may hurt some individuals depending on how they fall into the overall picture. I don't think we need to become alarmed about the elimination of some of these personal "perks" until we have a final look at the new tax packages in whatever form they develope.

II. LONG TERM CAPITAL GAINS AND LOSSES

There seems here to be uniformity in all of the proposals. From a strictly personal posture, I feel there would be less enthusiasm to purchase real property from the investment standpoint since part of the advantage of doing so would be wiped out. But more significantly, the risk taking in the high tech areas which we need so badly would be severely curtailed. New companies mean new jobs and correspondingly, tax dollars from profits and personal incomes. Both the Treasury and Kemp-Kasten Plans call for indexing which we have already discussed. Difficult to administer!

III. ITEMIZED DEDUCTIONS - PERSONAL

The Treasury Plan seems to be hung up with indexing as a "way of life". Since we are not speaking of business at the moment, we are looking at a large group of individual taxes payers (many who try to do their own tax work)...Indexing very well may make it impossible for an unqualified individual to handle this task. Why do we insist on making things more difficult when simplification is the order of the day. The Kemp-Kasten Proposal would have some adverse effects on consumer spending.

The elimination of various State and Local Tax deductions will have its opponents depending on how they are treated in the overall picture. This doesn't pose significant problems from my standpoint depending on the equity of the overall plan.

I am extremely opposed to the elimination of the charitable deduction in any way. Here is a voluntary system of raising monies for a multitude of various organizations who perform many of the benevolent duties which otherwise might, by necessity, be forced into the government sector. It makes no sense to move it from one hand to the other. . . again, no simplification. This paragraph is obviously aimed at the Treasury Plan since the others make no change in the deduction of charitable gifts.

Medical expense deductions will be more difficult to take advantage of in two of the three plans. The Bradley-Gephardt and Kemp-Kasten Plans both call for increasing the floor from 5% to 10% of the adjusted gross income. The Treasury Plan will remain at the present 5%. To me as a small businessman, none of the plans are difficult to live with; but, to the masses, raising the floor to even 5% may be a hardship at times.

Employee business expenses remain unchanged in the B-G and K-K Plans with the Treasury Plan putting a 1% adjusted gross floor. If an individual incurs expenses in the production of income, they should be entitled to deduct them from "above the line".

IV. TAX FREE INCOME

All three proposals eliminate the tax exemption for income from state and local bonds issued for private use. This could be devastating to small communities in South Dakota who use this form of financing to attract new industry to their communities. New industries...new jobs...new tax monies.

Health care is obviously the business to be in. Either the plans want to tax the income for dollars contributed towards health care premiums or they want to eliminate deductions arising out of sickness. As I stated before, the small South Dakota businessman may not be tremendously affected by them, but millions of Americans will scream "foul".

Another cut which seems unfair to any employee is the taxing of educational expenses relating to job. It seems that we again see counterproductive moves by the writers of these proposals. Better educated employees command more salary dollars which should, if the new tax bills are done with equity in mind, produce more tax dollars.

V. RETIREMENT SAVINGS
This section is a banking/investment/personal area which I will forego making many comments on except that we need to encourage private retirement funds in order to take the pressure off the Social Security System.

VI. TAX SHELTERS
Again, not having a great feel for this area, I will limit my comment to my perception that this along with interest deductions may have a negative affect on real estate values(at least those of the investment type).

VII. TAX CREDITS
Here we have the area where we will hear lots of screams from varied types of people. The reason for this is,now we are directly getting into one or anothers pocket. We all have enjoyed one or many of the "tax credits" whether it be personally or through our businesses. Tax credits are at least partially government's way of controlling a sector of the economy. This was done through jobs credits, energy credits, rehabilitation credits,etc. This may be an area where lobbyists will really put the pressure on.for their own special interest groups. Whether elimination of the tax credits will adversely affect the small business sector(or how much it will) will depend on the overall package that comes out in the end.

VIII. BUSINESS TAXES
It appears that smaller corporations can get ready to grit their teeth with two of these proposals since the Treasury and B-G Plans have eliminated the lower corporate tax brackets. Under the Treasury Plan dividends will be tax deductible which will encourage their payment. The non-deductibility of corporate dividends has encouraged the growth of many corporations to the levels we see today. We again seem to be losing sight of that progressive and agressive nature that we need in the business sector to continue expansion of our economic base. A new tax system should not pull business into a status quo method of continueing, but rather should on the contrary encourage new growth through equitable and fair tax policies.

IX. DEPRECIATION
The Treasury Plan changes the present ACRS to a Real Cost Recovery System which would have seven classes of property with varying deductions for each and of course we must have indexing. We have now taken a fairly difficult system and tripled its complexity. Seems to me that we again have missed the object of our charge. Under the B-G Plan lives would be extended, special numbers applied, and we would have six classes of property. Still a far cry from simplification. In addition to the difficulty in administration of these proposals, small businesses, who many times depend heavily on depreciation expenses for survival, may very well be hit hard by this change. I also can see real estate (commercial and multifamily)values dropping because of the loss of this advantage.

X. OTHER BUSINESS DEDUCTIONS

The main thrust of this section is to limit travel, entertainment, bad debt deductions, etc. to a reasonable level or eliminate in some cases. I think, in general, small business in the Midwest is probably already within the guidelines in most cases. I certainly have no problem with the enforcing of good judgement in this area.

XI. RETIREMENT PLAN PROVISIONS

I do not have the knowledge to comment in detail about this section but, I would again like to encourage the writers of these proposals to expand tax legislation to enable broader participation in private(IRA's or corporate sponsored pensions) retirement plans. By encouraging private and corporate plans, future generations may not need to rely on a Social Security system which more than likely will be unable to take care of their needs.

XII. OTHER BUSINESS TAX PROVISIONS

The Treasury Plan makes one more stab at indexing in its "NEW FIFO" accounting proposal. Although the plan would have certain advantages to business, I'm not so sure that the added complexity is what this change is all about. I will leave the international provisions to those who have knowledge of them...

SUMMARY:

Although all of the proposals here have some merit, it seems that the underlying reasons for these changes may have been ignored or forgotten by the writers of them...a reasonable set of income tax laws which are equitable, easy to understand, and progressive to our economy. I'm quite sure that a more difficult task has not been undertaken, but it is long overdue and middle income America is insisting that it be done. Our Government, through insistence by special interest groups, has stepped into areas where it did not belong and has written tax legislation which it had no business writing. It did so at our request for services or breaks of one kind or another. It is now time for Government to get back to the basics and read its "Job Description". Fair tax legislation is only a part of the total concept which must be adopted. Budget deficits may very well be crucial to the success of any tax changes. America's business and its citizens will not tolerate unbalanced budgets being financed by inequitable taxation.

Senator PRESSLER. Thank you very much.

I am going to be getting back to asking you about some of the business taxes in a little bit.

Bob, would you like to go next.

Bob Ingle, we welcome you.

STATEMENT OF BOB INGLE, FARMER, HURON, SD

Mr. INGLE. Thank you, Senator Pressler.

As you probably notice, I am kind of a last-minute substitute here, and I did not have a prepared statement. In fact, I was going to speak a little bit more on the effect of agriculture with any type of tax plan.

I, too, am the third generation farmer on a little farm. I live southeast of Huron here My grandfather homesteaded and, in fact, I still have the patent signed by President Harrison deeding the land to the family. My son now has come back with his master's degree in business administration from the University of Kansas and is taking over part of the farm operation, and I am hoping that maybe he can continue doing this.

One thing I would like to compliment you on is some of the changes we have had in the income tax. This hasn't been mentioned and it is not quite in direct relation to what we are talking about today, but when I inherited it from my parents, some of the inequities and problems that I had I think are going to be solved when I pass it on to my son. And I hope you continue working on this inheritance tax plan to keep the family farm viable.

My father said at the time when I was growing up and started farming, "Well, Bob, you just hang in there and these tough times will soon be over. There is going to be a shortage of food in the world in a short time and you are going to be in the driver's seat."

You know, Larry, I still have that same old "M" that I am holding on to and I am still in the driver's seat. In 35 years, it doesn't look a bit better over the hood of that "M" than it did in 1950. But that is some of the things we have to deal with.

But I would like to talk a little bit about the importance of agriculture as we have it. It is really a little more important I believe to the small business world or business world than has really let be known in many circles in the East.

We find that there is $13.2 billion of tractors and farm machinery purchased on an annual basis under normal conditions. This employs 150,000 assembly line workers, and you equate that to our population of our three largest cities in South Dakota.

Along with this there is $16.4 billion used in fuel and maintenance and other supplies in the farm industry. Consequently you might say that a strong agriculture means a strong work force or a strong economy.

There are 23 million people, which makes up 22 percent of the total work force, that are earning their living in the food and fiber industry. Locally we are even higher than the 22 percent. In our Midwest we have between 30 and 40 percent of our work force involved in agriculture directly.

What did this do to us? Well, in 1965 to 1979 our farms declined from 6.4 percent of our population to 2.8 percent of our population.

This leaves us as quite a minority. At that time in 1965 we had 12 million farmers and now we are down to just a little more than 6 million farmers in 1979. I don't know what it would be now, but even less now. It has dramatically decreased in the last year or two.

But we did expand. We were told to expand. Back in the 1970's we were told to expand and produce food because this was the salvation for our economy. We needed it for the exports to counteract our loss of imports and for balance of trade. We were told to expand and we did so.

In order to do this we had several factors that were important for us. We were pinched, we needed income, we had to expand and we had to be more efficient and in doing so it did bring changes.

You find agriculture did expand. In 1965 the income for the farm was $43.5 trillion. In 1979 it went up to $148 trillion. That is how we did expand. We have almost expanded ourselves out of existence.

Right now I happen to be of the age of about 55; which is the average age for a person involved in farming. I think this shows that maybe we have a problem for replacements. In fact, it is just about impossible for anybody to even start up farming any more. We find that interest costs, which you are talking about in these plans, are a built-in cost right now in the farmer's operation. You just figure interest right into any and every operation as being part of the cost of production.

If interest payments were depleted for tax reasons, I think it would be very much of a mistake as far as agriculture is concerned. Investment credit during growth expansion was very, very important to us. At the present time investment credit, because of the lack of opportunity to make an investment due to the fact that we have no income to speak of, is not such an important point right now. But if we were to have a return on our investment, the investment credit would be very mandatory for economic expansion.

Depreciation, too, which is talked about here, is very, very important to the farmer. No matter what you get, we have to depreciate it. It just dies of its own natural death and when we sell it again it is gone. It is just plain lost and it is an operating cost and should be figured into it.

In looking through these plans, and I have not received this before today and so I am right along with the people in the audience, I cannot debate the individual merits of each plan. But I would like to say this. I think that all flat rate plans, as I look at them, would be very detrimental to agriculture. I can see no real help in any one of the three plans here for that reason.

We found that we had to have a computer for our expansion in our farming operation. We have had ag net records that show exactly what each cost of operation would be. These in turn were mandatory for us for our tax reasons.

In fact, my son went to grad school and he was going to try to work into tax work along with managing the farm. He looked at the changes in the IRS Code on an annual basis, and there are volumes about this high of pamphlets that come out just for revision. In order to digest this a person must study all the time.

He abandoned the idea in law school of going into that particular area and he went into economics and he is back on the farm with me now.

So we found that a computer was very necessary, and it is very important and it is mandatory for us to fill out our tax forms. No matter how simplified it is, there are enough changes that we work up computer records for that reason.

Another area that has been mentioned before is the effect of corporations and individuals using agriculture for tax shelters. A couple of the names that we find and have the largest seed corn companies are names like Ciba-Geigy and Pfizer.

Something that we were involved with this year was our feeding operation. We found direct competition. Now many of you applaud this for the reason that you are selling your cattle.

But we had Texans who were coming in, nonfarm operators, who were buying feeder cattle and taking them to Texas feed lots. Pot load after pot load went out of the western part of our State. This was in direct competition to us, and maybe that is healthy, but it is going to come right back to us again.

The egg and the broiler industries are controlled by many of the chains and bigger corporations. If you travel the southwest feed lots you will see many familiar signs on the feed lots relating them to other industries and businesses which are owned by larger corporations and conglomerates.

Foreign investors are also a part of it. Almost one-third of our money that was used in the Federal deficit I believe is coming from other foreign countries back into our country for shelters. Right in our own community we have a farming operation, and I think it is around 7 and 8 thousand acres, give or take a few. It is owned by a German corporation and is being managed and operated by a management company out of Aberdeen and is farmed by them directly.

Our legislature a few years ago did change and outlaw foreign investors of this type. So at that point it is not a very big factor, but in other States I see that it is still a problem.

One of our biggest problems, as I see it, is pretty well defined by an individual that I would like to quote, Mr. Donovan Loeslie, who is vice president of the Minnesota Association of Wheat Growers. He is also the former president of the National Association of Wheat Growers. I would like to quote him at this time. I think he has it very well stated.

"The real problems farmers face," Loeslie states, "is the huge Federal deficit which places tremendous pressure on the demand for money and maintains interest rates for farmers at very high levels. High interest rates increase the cost of production and lower farm prices received by farmers. The impact of interest rates is now even greater since farm debt has increased to more than $225 billion, which almost approaches the Federal deficit."

Loeslie has cited a farm credit services survey in Texas which showed a 1-point decline in interest rates would be equivalent to 9 cents a bushel more for crops produced by the average farmer. If we could lower interest rates from the current 14 to 15 percent to 9 to 10 percent, it would mean as much as 45 cents per bushel for the average farmer. For the highly leveraged producers interest payments equate to 13.5 cents per interest point. Dropping interest rates from 15 to 10 percent would mean 67.5 cents per bushel more for those highly strapped producers.

High interest rates paid by manufacturers and suppliers of farm machinery inputs are passed on to the growers in the form of higher costs, Loeslie noted. High interest rates and the resultant effect on the value of the dollar have been a double-edged sword from the standpoint of also stimulating increased production from other nations he says.

Really any tax plan that right now interferes with the growth of agriculture is a detriment.

Thank you, Larry, for this chance to speak to you.

Senator **Pressler**. Thank you very much.

Joseph Statz, I shall call on you at this point.

STATEMENT OF JOSEPH STATZ, STATE SNYDER DRUG, PARKSTON, SD

Mr. **Statz**. Thank you, Senator Pressler.

I am a pharmacist. I own three drug stores, one here in Huron, one in Mitchell and one in Parkston which is where I live.

I think my favorite banker, Bruce Odson, is responsible for me getting here. I am not a political person. I don't have a prepared speech.

But I do know what Bruce said, and let's just refer to one of the remarks Bruce made in his comments about major corporations and achieving big tax savings. And I am going to refer to what Bob Ingle referred to also in his talk about a couple of cousins of mine that I am familiar with, Ciba-Geigy and Pfizer, and I will get into that later.

But major corporations and what they do to taxes is I think what these two lions Kemp and Bradley, a couple of ex-jocks, are trying to get elected President on. And if they can get the populace of America behind this, I think that they have something going.

I am not going to refer to what it is going to do for me as a pharmacist individually or corporately, but what it does to the senior citizens of South Dakota or anywhere in the United States who are coming in and paying these tremendous prices for prescription drugs. It is a crime, and the inflation is killing an awful lot of elderly senior citizens, not only in South Dakota but all over America, and there should be some way in which we could ease that burden taxwise. And if these two young lions can get it done in Congress, I am all in favor of it if it helps the majority of the people in America.

I, too, talked to my accountant, and he said it is very difficult to write an individual's return. He said it is not difficult to take care of your return, you have got three drug stores, but he says I have some clients that have 17 businesses. He said they juggle around in those businesses for tax favors. They jump into this and out of that and they look at the Internal Revenue Code as it is written and interpreted and they make money just by jumping around, depending on the way the code is written.

I also understand that years ago in the code there was something written that nobody understood. The CPA's didn't know what it was and no one knew what it was. They came to find out sometime later that it was a film director in Hollywood who had gotten his Congressman in California to write in favorable legislation that affected only him. He is a popular name, but I won't mention the name because it is just conversation. It may not be true, but I think it probably is.

I guess the real big question would be what is H&R Block going going to do in the future. They won't have anything to do if everything gets so simple.

I found it very interesting to listen to Joe, the farmer from Lily, SD, comment about what was happening to farmers because some of the same things that he was commenting about were the same things that David Stockman said the other day on television that seemed to be very unpopular from what I heard.

A lot of farmers in South Dakota and all over the United States thought that they were very unpopular remarks to make about the farmer betting himself in a hole and then expecting the Federal Government to bail him out. And, yet, Lee Ioacoco, who is one of the most popular men in the world according to statistics that I have read got bailed out and so did the railroads. I guess that if I were a farmer I would think that maybe there should be some help for me, too.

Just briefly then I want to comment as a pharmacist that the thing that I would see that needs to be done most for people in South Dakota is the elderly, some way in which people on a fixed income, and many of them only have Social Security checks, and when that person has to come in and lay down most of that Social Security check for prescription drugs, I feel very bad about this.

But let's go back to Pfizer. We talked about Pfizer. They are a major company. They have a new arthritis drug called pheldyne out. They brought it out in 1984 sometime I think at about 80 cents a capsule, and I thought, my God, I will never see the day when somebody would pay over 50 cents for a capsule and that would be an antibiotic that you would take for a short period of time. It is only a one-a-day capsule, and now it is over a dollar in most pharmacies.

Now the reason Pfizer can charge a dollar is because they are the only one making it. They will have a 16-year protection on the patent and if a person has arthritis, which an awful lot of people do in America, they are going to take the drug and pay it.

So I guess if I were to send you back to Washington in behalf of my talk, I would like to see you help the senior citizen because I feel most sorry for them because they pay the big bills every month and they just don't have it.

If there is any more that you would like to know about my feelings on that, I will be glad to talk about it. Generic drugs is one way that senior citizens can save money or anyone else, for that matter, but doctors don't know about these things. They don't pay attention to costs. They just pay attention to the effectiveness of the drug.

I have diversed enough from what you are here to hear about. I read an article in Ink Magazine and they said if these two young lions can go out and create the interest on the part of the American people, one or both of them might be up for President sometime. I don't know whether it would be good for me taxwise to get a level tax. It is kind of like a sales tax really. If it is level it would be a sales tax. If it helps the majority of the elderly in America, I am in favor of it. Thank you.

Senator **PRESSLER**. Thank you very much.

I might ask Mr. Anderson or any volunteer, for small retailers the accounting of inventories plays a major role in ultimately determining the taxable income of business as a whole. The Treasury Department has proposed modifications in the current accounting of inventories for tax purposes.

In your opinion, do we need to make some changes in the current rules regarding inventories?

Mr. **ANDERSON**. Well, the proposed changes in I guess it is the Treasury plan is asking for indexing again to be put into a new FIFO accounting proposal. Although I think that plan has some advantages to business because you are only including as income that portion of your increase in inventory that isn't due to inflation, I am not so sure that the added complexity of that type of thing is what this change is all about and what we are really looking for.

Senator **PRESSLER**. My problem with the three proposals is that when you get into them they are as complex as what we have got and you are back down the same road.

Mr. **ANDERSON**. Yes; I think we keep losing sight of the fact of what we are really trying to do and we need to keep those blinders on and head for that point down the road.

Senator **PRESSLER**. In the machinery business is there any need for change in the way inventories are figured?

Mr. **BECKMAN**. I don't really understand what all the ways are. I think the IRS has been trying to get everybody to get higher values on inventories. A few years ago they came out with a rule regarding obsolescence. I think it was in regard to a company where they had written off a bunch of obsolete inventories without actually throwing it out and they disallowed that.

In our business we get quite a bit of obsolete inventory that we would like to write off, but still keep it around for maybe some day a little part of it would be salable. But right now they don't allow that.

Senator **PRESSLER**. That is significant. I always emphasize that I don't fully understand the Tax Code. I am trying to more and more, and I appreciate your statement. This morning we had some leading businessmen, a professor from the University of South Dakota, and a tax lawyer, and they all said that it was almost impossible to fully understand what some of this meant unless you were audited. I think that clearly indicates that we really need a simplification and clarification.

Do any of you have any feelings on the elimination of the preferential tax treatment of capital gains that has been proposed and would that affect your businesses? Maybe this is something that you haven't had a chance to prepare for.

Mr. **BECKMAN**. Well, I think I touched on it a little bit. I don't think that they should do away with capital gains, or I am not so sure there should even be any capital gains tax on that part of the gain that is due to inflation. I just see no justification for it.

Senator **PRESSLER**. So then you would index the basis because someone is paying a tax basically on inflation. That is your point?

Mr. **Beckman**. That's right, particularly where you are talking about real property where the use hasn't changed, or something like that.

Senator **Pressler**. OK.

Mr. **Anderson**. Are you referring to the differentiation between a corporate and a personal? Is that the question you are asking?

Senator **Pressler**. Yes.

Mr. **Anderson**. Because I think the tax changes do handle them differently, if I am not mistaken.

Senator **Pressler**. Yes.

Mr. **Anderson**. I think from a personal standpoint you are not allowed—they tie it to a net investment income, or I guess maybe that is on the interest. Well, they do treat it differently between corporations and individuals, and I don't feel that is a fair situation.

Mr. **Hudson**. I would say for the purposes of how you are able to attract investment in your own business or perhaps your treatment for personal capital gains.

Mr. **Anderson**. Absolutely. I mean we have to have, I think, equity in whatever change we have, whether it be a multinational corporation or whether it be a small operation in Huron, SD.

Senator **Pressler**. Also in your fine statement regarding business taxes you have a thoughtful portion in which you say:

> It appears that smaller corporations can get ready to grit their teeth with two of these proposals since the Treasury and the Bradley-Gephardt plans have eliminated the lower corporate tax brackets. Under the Treasury plan dividends will be tax deductible which will encourage their payment. The nondeductibility of corporate dividends has encouraged the growth of many corporations to the levels we see today.
>
> We again seem to be losing sight of the progressive and aggressive nature that we need in the business sector to continue expansion of our economic base.

What are you saying there?

Mr. **Anderson**. Well, with the laws the way they are written at this particular point, the corporate dividends are held as retained earnings. Under one of the proposals if they distribute those incomes to the individuals who own the businesses, they will be tax exempt to the individuals rather than the way it is now.

Under that kind of a system rather than holding those dollars corporately and using them for the increases in the business itself and reinvesting those dollars for expansion or whatever, they would be lost under at least one of the proposals, and I have lost my notes now.

Senator **Pressler**. OK. That's all right.

I wonder if each of my colleagues has one question because we are running out of time here. I will ask each of you if you have just one question here.

Mr. **Hudson**. Well, I guess I would throw this one out to Bob. You made a good statement on sort of the history of how you came to be a farmer and how you stayed a farmer. My question would be if we eliminated all credits and deductions and we imposed, unlike these plans, really one rate of tax on both corporate and individual, that would be a change from the current and progressive nature of taxes. Would that be something that you would support?

Mr. **Ingle**. It would be very hard without a critical observation of the tax and the way it would be applicable to the individual. But as I see it, it would eliminate almost all the deductions the farmers have at the present time. It would be paying on our gross income, which is not what we have as a real income. Our gross is far from that. We have very, very few dollars that we take through our hands each year that we actually have as net income.

This way it looks like to me with the flat tax from what I can see of it, it will be on our gross income without allowing our deductions that we have at the present time and it would just be a murderous tax.

Mr. **WALSH**. In an earlier panel Mr. Odson suggested a transition from current taxing to a reform tax that changed 20 percent in 1 year, 40 percent the next year and 60 percent the next year. So you could have a gradual transition to a new tax system.

One of the problems confronting Congress I think is just that problem, and that is how to achieve any kind of smooth transition. I thought it was a pretty good idea and I wonder if the other members of this panel have any comments on that?

Mr. **STATZ**. I think that most anybody that is in a business would have a CPA helping him with his taxes, and I am sure they could figure a way to handle that very smoothly, and I don't think that would be any problem at all. I think that would be a good way to do it, the way Bruce's firm suggested.

Senator **PRESSLER**. I want to thank this panel very, very much. You have given excellent testimony, your response to questions has been excellent and it will be very valuable to the Small Business Committee and to the tax writing effort. I think you made some good points.

One signal that came through very clear here today is that people don't want a new tax bill for the sake of a tax bill. Senator Packwood, the chairman of the Finance Committee says that maybe we should not have a new tax bill but have some amendments to try to close loopholes. Certainly in considering any major new tax bill, it seems to me, that we should have tax simplification as our goal.

I think the three plans as presented, the Bradley-Gephardt, the Kemp-Kasten and Treasury all have variations in them that almost heads us back down the same path that we are on, except we would have a new code. Of course you never get a chance to vote simply up or down on these things, but we probably will have basically these proposals before us with amendments.

As I have listened here, I think unless we are going to really go to tax simplification, I am not so sure we would be moving the ball ahead by just passing a bill.

Let me thank you all for being here.

This concludes this hearing.

[Whereupon, at 4:25 p.m., the committee recessed, to reconvene at 9 a.m. in the Lincoln Room, Alex Johnson Hotel, Rapid City, SD.]

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

THURSDAY, FEBRUARY 14, 1985

U.S. Senate,
Committee on Small Business,
Rapid City, SD.

The committee met, pursuant to notice, at 9 a.m., in the Lincoln Room, Hotel Alex Johnson, Rapid City, SD, Hon. Larry Pressler (acting chairman of the committee) presiding.

Present: Senator Pressler.

Staff present: Stewart J. Hudson, professional staff member; Lawrence G. Dalsin, professional staff member; Tom Walsh, tax counsel, and Tom Hohenthaner, professional staff member, office of Senator Pressler.

STATEMENT OF HON. LARRY PRESSLER, A U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator **Pressler**. I will begin by thanking you all for being here. Good morning.

From the Floor. Good morning.

Senator **Pressler**. I should go around the room and shake hands with everybody because I know everybody here.

I hope you can hear me in the back of the room.

Let me say that holding these tax simplification hearings has been very revealing to me because many of our citizens know a great deal about taxes and feel strongly about them.

There are three basic tax simplification plans that have been presented in Washington this year, but really none of them are really simplified very much. That is what I have concluded so far, but they are a first step.

But I want to hear any ideas that you have on taxes and they don't have to be in connection with these three plans. Some of our service industries, for example, aren't able to take advantage of depreciation and certain other industries can't function under certain other parts of the code.

Our whole tax law has gotten too complex. They had a big rewrite of the tax law in 1954 and it wasn't rewritten again until about 1969. Back in those days most people filled out their own tax forms. Then from about 1969 there have been tax changes every year more or less, and sometimes the IRS isn't even able to implement all the regulations before the next tax bill is passed.

One businessman in Huron yesterday said if we would just not pass a tax bill for a few years so people could start to understand what the code was all about.

We need to do our job better in Congress insofar as the whole tax situation is concerned. Close to 60 percent of Americans believe that the Tax Code is unfair or they can't understand it and we do have a very great need for tax simplification. On the other hand, the way change would affect agriculture and the way it would affect small business in this State is something we have to consider.

I know that some people who have come to this meeting may have some other business to discuss with me totally separate from some of the things that we are discussing here. I have a couple of case workers with me.

I am very pleased to have some of the Small Business Committee staff with me, Steward Hudson, Tom Walsh, and Larry Dalsin, all of whom are here, and are experts on the tax structure as it affects small business and agriculture.

We are going to use the testimony here in the Small Business Committee. Also, I am going to make a presentation to the Finance Committee in the U.S. Senate on some of the things that I pick up.

So basically with that, I am going to keep things moving along here this morning because I know a lot of our businessmen have got to be back at their jobs to make money so they can pay their taxes. [Laughter.]

I am going to call the first panel forward. I think we will start with Dr. Charles Lein, Stan Adelstein and Sherwood Corner, Woody Corner. If they would come forward. We have little name cards here for you.

Let me say that I have handed out what these three charts are. I should just explain that. What has been handed out looks terribly complex and I must go over it before we hear the witnesses.

These charts correspond to the sheets that you have. There is the Treasury Department proposal, the Bradley-Gephardt proposal, and the Kemp-Kasten proposal. And it is not at all necessary that you understand these to testify or indeed to have ideas on how to change taxes.

In fact, some of you who are not a witness, are most welcome, if you have ideas on the individual income tax returns, to give a written statement. That is fine and we will make them a part of the record.

But the point I think that these three charts and handouts illustrate is that each of the tax simplification plans has its own favorite deductions and credits to retain or to disallow.

If you look through it, it isn't really tax simplification and we are back in the same old boat again. That is something that is very important to take a look at.

You can follow it down on each proposal and see how they differ.

But in any event, I am going to call on some of the witnesses here.

I think to start this off I will call on Chuck Lein, who is president of the Black Hills Gold Jewelry Manufacturing Co., former president of the University of South Dakota and a very good friend.

Chuck.

STATEMENT OF DR. CHARLES D. LEIN, PRESIDENT, BLACK HILLS GOLD JEWELRY MANUFACTURING CO., FORMER PRESIDENT OF THE UNIVERSITY OF SOUTH DAKOTA, RAPID CITY, SD

Dr. LEIN. Thank you, Senator.

I am pleased to have the opportunity to appear before you today and provide some observations, opinions and recommendations regarding proposed revisions in Federal income tax laws and some perceptions regarding the role of the Federal Government and its relationship to the small business community of America.

As Congressional representatives, you and members of the executive branch are to be congratulated for your recent actions in bringing inflation under control, providing a series of meaningful incentives for business investment, stimulation of the American economy, the creation of new jobs in the private sector and the downward trend in the employment rate.

In my very biased opinion, Congress must now aggressively reduce the magnitude of the Federal Government, reversing an uninterrupted trend which has occurred during the past one-half century.

In our haste to address almost any and all of our Nation's problems by saying "the Government ought to do something about it," we have allowed too many bureaucracies to evolve and to go unchecked.

Since President Eisenhower left office, over 240 departments, agencies, bureaus and commissions have been created at the Federal Government level alone, and fewer than 25 have been eliminated.

As you and your colleagues address the numerous challenges with which you are confronted, please remember how we got to where we are in our society. Business and finance in a quasi, laissez faire free enterprise environment has and will more effectively and efficiently respond to our Nation's needs than will government at any and all levels.

A current national problem indirectly related to evolving Federal tax legislation centers around the growing international trade deficit. While our small company in Rapid City has tried to develop an international market for our product, the current premium of the American dollar in relationship to all other currencies in the world, together with extremely high import duties, restrictions, and red tape have basically caused us to at least temporarily abandon any plans for the significant exportation of our product.

As you and your colleagues examine the various proposals for tax reform, you must maintain a high level of objectivity and readopt a commitment to what I refer to as being the doctrine of fairness.

Perhaps every individual and business tends to perceive that the best and most fair tax is that which somebody else pays. Change is going to be difficult, and during your deliberations you will hear from every special interest group in the Nation.

After examining the details of the Treasury Department plan, the Bradley-Gephardt plan and the Kemp-Kasten plan, I have concluded that the Kemp-Kasten plan is the most desirable of the three major alternative proposals being considered.

Because of the multiple interrelationships within each of the proposals, it is obviously not possible to significantly tinker with or pick and choose the most desirable and undesirable elements of the various plans.

Among the reasons for supporting the Kemp-Kasten plan is it achieves the flat tax objective; it generally preserves an incentive environment for private investment and personal savings, such as through IRA's; it allows the continued deductibility of State and/or local income taxes; it retains the newly adopted indexation philosophy; it allows for a transitionary period for the treatment of long-term capital gains; it treats capital losses as tax preference items; it retains the status quo regarding most current employer-provided fringe benefits; it retains the ACRS depreciation system; it retains current LIFO and FIFO inventory evaluation alternatives and it also retains the current format for the cash method of accounting.

The Kemp-Kasten plan appears to be far more simple in its format and it would be easier to implement and understand than either the Treasury Department plan or the Bradley-Gephardt proposal.

Irrespective of what plan might be adopted, may I emphasize one critical consideration which I feel must be incorporated into any change or changes. Effective managers anticipate and plan for the future. Most business persons make dozens of decisions every day. Those decisions, like those of a football quarterback, are made in light of the existing conditions and existing rules of the game.

At a recent tax proposal conference held in Rapid City, a Treasury Department staff person inferred dismay and criticism toward the business community for making business decisions partially on the basis of tax consequences. Because of the existence and the magnitude of corporate taxes, such must be a part of the matrix surrounding most business decisionmaking processes every day of the year. It is not only logical, but it is also appropriate that tax consequences have in the past and will in the future influence such decisions.

With that in mind, it is imperative that any radical changes in tax law be either phased in over a period of time and/or there must be a grandfathering of the tax related conditions upon which personal and business commitments have been made.

I appreciate the opportunity to appear before you and we wish you well in your deliberations.

[The prepared statement of Dr. Lein follows:]

(Statement by: Dr. Charles D. Lein
President and CEO, Black Hills Jewelry Mfg. Co.
dba Landstrom's Original Black Hills Gold Creations
405 Canal-Street
P.O. Box 3100
Rapid City, South Dakota 57701

(Before the U.S. Senate Small Business Committee
(Subcommittee on Federal Tax Reform Proposals

February 14, 1985

I am pleased to have the opportunity to appear before you today and provide some observations, opinions and recommendations regarding proposed revisions in Federal income tax laws, and some perceptions regarding the role of the Federal Government in its relationship to the small business community in America.

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Because of the mutiple interrelationships within each proposal, it is obviously not possible to significantly "tinker with" or "pick-and-choose" the most desirable and undesirable elements of the various plans. Among the reasons for supporting the Kemp-Kasten plan are: it acheives the "flat tax" objective; it generally preserves an incentive environment for private investment and personal savings, such as through IRA's; it allows the continued deductibility of state and/or local income taxes; it retains the newly adopted indexation philosophy; it allows for a transitionary period for the treatment of long-term capital gains; it treats capital losses as tax preference items; it retains the status-quo regarding most current employer - provided fringe benefits; it retains the ACRS depreciation system; it retains current LIFO and FIFO inventory valuation alternatives; and it also retains the current format for the cash method of accounting. The Kemp-Kasten plan appears to be far more simple in its format and would be easier to implement and understand than either the Treasurery Department plan or the Bradley-Gephardt proposal.

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Best wishes in your deliberations.

Senator **Pressler**. Thank you very much.

I will now call on Stan Adelstein who is president of the Hills Materials Co., Northwestern Engineering and other business interests, a very good friend and a very prominent businessman in our State.

Stan.

STATEMENT OF STAN ADELSTEIN, PRESIDENT, HILLS MATERIALS CO., NORTHWESTERN ENGINEERING AND OTHER BUSINESS INTERESTS, RAPID CITY, SD

Mr. **Adelstein**. Thank you very much, Senator. I appreciate being invited to testify today.

While we are talking about future tax legislation, I would like to at least touch on one particular problem that we are all facing right now of which I think you are aware, and that is the Treasury rules requiring absolutely unrealistic recordkeeping for the use of corporate vehicles.

We are a small company, but we operate some 62 pickup trucks and about 18 or 19 passenger vehicles. This is really not productive of producing additional revenue for the Government. It is a strange sort of almost harassment, and we would hope that something can be done very shortly to eliminate this procedure.

Moving now into the various bills that have been presented in terms of future legislation, in an examination of the three proposals, I find that it is necessary for me to a certain extent to cut and pick.

I would like to address it in two matters, one having to do with the personal tax portions and the other having to do with the corporate.

Let me begin by saying that while I honestly believe that the revisions that have taken place since President Reagan became President are advantageous overall, I must honestly say that they are more advantageous to those of my class, and I admittedly feel that perhaps we are no longer paying the share that we should have at least in several areas.

I think that if we feel the taxation has two purposes, one, to collect revenue for the Government and, second, to implement important social policies, then the two must be separated and weighed rather carefully.

Obviously there is a third aspect, and that is the provision of goods and services to American people of the highest quality at the lowest cost.

So let me address it from those three points of view.

First of all, with regard to shelters. I believe that except for the industrial development bonds that most shelters which were originally established to provide a social service through the medium of taxation have failed. I think that tax shelters should be examined and the only ones that should be allowed to remain are industrial development bonds, regardless of their purpose, because they encourage investment in areas that are necessary for, particularly in smaller towns in the United States where credit dollars are not necessarily available.

With regard to deductions for charity, I am dismayed that in all three bills there is an attempt to reduce the amount that is allowed for charity. I believe that this suggests an underlying fear of private enterprise in individuals solving problems that those in Government would rather take away from us and solve for us.

I would hope that the charity deductions presently allowed will be continued. They are a powerful incentive and they allow the dollars to go where they are needed as perceived by those close to the needs.

I must say that while I have had great personal advantage of it, I think the 15-year depreciation on real estate is unrealistic and unfair to those who are unable to make investments in that area, and I think that something more realistic should be reinstituted admitting that this will injure me personally and our company.

With regard to elimination of averaging, while I have no reason to take advantage of it, I am also an adjunct professor at the School of Mines and averaging is a significant part of the planning of college students and I would hope that it could be continued. If there must be some sort of a change, that it could be a change that would limit averaging to a certain period in a career.

The elimination of section 337, Collapse of Corporations, would be very unfortunate and I can find no rationale for its elimination.

The present law and its continuation would permit the ending of a corporate structure and would avoid a double taxation which is certainly unfair to those who have made investments.

In terms of the corporate taxes, I think if we realize that ultimately the managers of corporations must look to the return on the investment of capital and that taxes either decrease or increase that return, and increased taxes increase the cost of goods and services or reduce the effectiveness or efficiency, then we must look at which taxes would make a difference and which would not.

I am convinced that depreciation as presently used as guidelines for equipment as differentiated from real estate is an effective way of providing, particularly in the construction industry, of providing high quality at relatively low costs. I think that its change would not be effective and would be passed on at higher costs to industry.

The investments tax credit, once again something that is frankly very favorable to such industries as construction with high capital investment, have some other aspects in that in our smoke stack industries and in other areas it permits the provision of equipment to firms who otherwise could not get it and I hope it will continue.

I noticed that the personal holding company has been eliminated in all laws. I hope that that is absolutely carried forth. It is an archaic provision which really interrupts business practices.

Last, I would like to touch on the 50-percent dividend deduction. I think that elimination of this double taxation will encourage corporate growth and will encourage investment by more and more people in our society, and I very much am in favor of this deduction.

I guess, lastly, one general issue that concerns me because of my experiences in both Brazil and in Israel, and that is with the topic of indexation. I am concerned about indexation in any part of our economy because I have seen in those two countries that indexation leads to an acceptance of the concept of inflation.

I would urge that the process of indexing in taxes and elsewhere in the economy be carefully weighed for its realistic advantage as opposed to the attitude that it engenders in the society.

Thank you for inviting me today, Senator.

Senator **Pressler**. Thank you very much, Stan.

I shall next call on another good friend, Woody Corner, the owner of Corner Construction Co., Howard Johnson Motor Lodges and president of KEVN-TV and other activities.

Woody, we would like to hear from you.

STATEMENT OF SHERWOOD (WOODY) CORNER, PRESIDENT, CORNER CONSTRUCTION CO., HOWARD JOHNSON MOTOR LODGES AND PRESIDENT OF KEVN-TV

Mr. **Corner**. Thank you, Senator.

I have a statement that I want to read from here. It is short, but it is kind of simple.

I am really much against several of the items in the U.S. Treasury Department's tax reform proposal and I outline them in six items.

To eliminate long-term capital gain and classify it as ordinary income would stifle any incentives for investments of any kind for the small businessman.

On the proposals you submitted, all three proposals eliminate investment tax credit, and I believe that would do away with any incentive to remodel, expand, buy new equipment or anything else.

Item 3, to eliminate all industrial revenue bonds which are tax free to the buyer would leave the developer no alternative but to arrange a straight mortgage loan with the bank. This is almost impossible to do with the banks because of their high rates, their short-terms and all their openers on interest every few years. It will stop any new building or development of any kind.

In reference to the accelerated cost recovery, we have changed this so much that it is confusing. It used to be 33 years. A few years ago they changed it to 15 years, and now back in June of 1984 they changed it back to 18 years. I wish they would leave it alone so everybody would know what was going on.

On the present corporate tax, we have about 15 different brackets presently. All three proposals that you submitted to us cut that down to maybe one, two, or three brackets. I don't see anything wrong with that at all.

As Stan mentioned, in reference to indexing, I think it is very complicated and it is uncertain to the small businessman. If you eliminate the capital gains and go to a certain percentage each year based on your gross national product or your inflation or your appreciation or what, I don't think we will ever understand it.

If I interpret it right, the Treasury Department is trying to raise about $165 billion a year. Much of this tax would come from the construction industry and from the elimination of capital formation incentives, and I believe it would seriously affect the construction industry.

As a final statement, I am in favor of the simplification of the taxes, but I am dead against tax increases.

I say why not cut the huge Federal deficit and possibly eliminate 10, 15 to 20 percent of our Government employees and see what we have got left for a budget.

Thank you.

[The prepared statement of Mr. Corner follows:]

Statement by Sherwood L. Corner, President, Corner Construction Company before Subcommittee on Senate Small Business Committee, February 14, 1985.

I am very much against several items in the U.S. Treasury Department's tax reform proposal as outlined below:

1. To eliminate long term capital gains and classify it as ordinary income would stifle any incentives in investments of any kind.

2. All three proposals eliminate investment tax credit and I believe that will do away with any incentive to remodel, expand, buy new equipment, etc.

3. To eliminate all Industrial Revenue Bonds which are tax free to the buyer would leave the developer no alternative but to arrange a straight mortgage loan with the banks. This is almost impossible to do with the banks because of their high rates, short terms, openers on interest every few years, etc. It will stop any new building or develpment completely.

4. In reference to ACR's (Accelerated Cost Recovery), they have changed this so much that it is confusing. It was 33 years, then a few years ago they changed it to 15 years, now in June of 1984 they raised it to 18 years. Why not leave it alone and see what it will produce.

5. On the present corporate tax we have about 15 different brackets. All tree proposals want to cut that to 1, 2, or 3 brackets. I think that makes sense.

6. In reference to indexing, I think it is very complicated and uncertain to the small businessman. If you eliminate the capital gains and go to a certain percent each year based on GNP, inflation, appreciation, etc. I don't think we would understand and ever know where we are at.

7. If I interpret it right, the Treasury Department is trying to raise about $165 billion per year. Much of this tax would come from the construction industry and from the elimination of capital formation incentives and I believe it would seriously effect the construction industry.

I am in favor of simplification of the tax laws, but I am dead set against tax increases. Why not cut the huge federal deficit first and about 25% of the government employees and we will see what we have left.

Thank you for the opportunity to be at your hearing, Senator Pressler.

Sherwood L. Corner

Senator **Pressler**. I thank all three of you.

As you know, the various tax reform proposals reduce or eliminate the preferential tax treatment of capital gains. How important is preferential treatment of these gains to the profitability of your business, or not necessarily yours individually, but what would be the effect of eliminating them.

Do any of you want to make a comment on that?

Mr. **Adelstein**. I mentioned it and Woody mentioned it and I absolutely agree with him. The capital gains encourages one to make unusual capital investments that won't mature until over a period of time. Otherwise, and once again we talk in terms of return on investment, it allows a return on investments which otherwise might be marginal though they are absolutely valuable to the society.

For example, we operate the largest mobile home park in Rapid City. Always in our mind was the ultimate value of that property and the fact that its ultimate gain would be taxed at a lower rate. We provided thus a service which otherwise might not have been available had we not had that incentive available to us.

Senator **Pressler**. The various proposals all mention the so-called useful life of many kinds of depreciable property, including in some instances farm property, business property and so forth. What effect would changes in that current depreciation tax have on your business? Do any of you have a strong feeling on that?

Mr. **Corner**. Well, of course, you have got to have it, Larry. They have fooled around with it so much, I don't know where it is. Isn't at 18 years now? It was 15 and then they changed it in June to 18? I don't even know what they are going to change it to. But you have got to have it. For any type of business you have got to replace your equipment, your buildings, your furnishings or anything eventually and you need that depreciation. You cannot do without it. I don't care if they lengthen it or not, but I wish they would stabilize it and leave it there so everybody knew what was going on.

Dr. **Lein**. I would echo what Woody said with regard to the necessity for stabilization. I think that some logic obviously has prevailed in establishing the different parameters, and you could argue almost any level. But in order to make intelligent decisions and ride with them, you need to have some form of consistency from year to year.

I think that the logic that has tended to prevail in recent years has been to encourage private investment and to encourage capital investment which will stimulate the economy and creates jobs. Those things seem to be consistent with the prevailing philosophy we have historically had. That is, to turn to the private sector to create jobs which have a lasting effect rather than to turn to the Government to create jobs, which is a very temporary and band-aid approach to problem solving.

I guess the bottom line is to seek stabilization rather than jumping all over the place from year to year.

Mr. **Adelstein**. I think we need to separate the two categories of real estate investment from equipment investment. As the other two gentlemen have said, in order to keep your fleet modern and efficient and provide the cost and efficiencies that we have, that the present guidelines I think for equipment plant and equipment are realistic.

I think whether the 15 or 18 years frankly is not realistic. It is certainly to my advantage because half of my company is involved in real estate, but I must say that I don't think that that is fair overall in revenue producing. I think that it should be established, as both gentlemen say, in a way that we know, but I think that lengthening would be fair and would not act as a disincentive to real estate investment.

Senator **Pressler**. Let me be the devil's advocate on the investment tax credit. That does allow for substantial reduction in initial costs of investment in depreciable property, and all three of these proposals would repeal it, and we have heard the opposite view here this morning.

What impact on the Rapid City community would repealing the current investment tax credit have on investment and business activity?

Mr. **Adelstein**. I would say just off the top that it would increase the cost of construction in this community between 4 to 7 percent because if the cost of equipment is an important and essential element in construction, that ITC is an effective way of reducing the costs of equipment that produces particularly in the construction industry with which I am aware.

Mr. **Corner**. Like Stan says, he is probably about right on that, but that really affects the big manufacturing plants in the East. You get into the automakers and everybody else, that is a big incentive for them to build new facilities and everything else. Those are probably going to be the major objectors to doing away with that part of the tax laws.

Dr. **Lein**. One of our concerns nationally has been with regard to the relative level of productivity of our work force. I think that we have witnessed in many industries a relative decline of productivity that is well documented. I don't know if there has been a cause and effect relationship between our turning the corner in some industries, but many in fact have become increasingly modernized and we have witnessed significant improvements in terms of productivity. Whether that is machine driven or people driven is probably debatable.

But I would certainly anticipate that investment tax credits have if as a result or been at least a partial stimulus to the upgrading equipment and the overall manufacturing environments. As the result, we have increased our relative productivity and we have become more competitive with countries we once outperformed in the international arena.

I would say those are all good things, and I would concur with my colleagues with regard to how that does in fact stimulate business people to make decisions to upgrade their plant and equipment.

But, again, I realize if you start picking and choosing the best from all of the alternatives, you are going to end up with a real "hodge-podge." The bottom line is you are going to need to generate certain levels of revenue. I hate to speculate, but I frankly feel that you are going to go through a lot of wailing and mashing of teeth and you are going to hear from lots of corners of our society.

After all is said and done, I don't think the odds for significant change are very great. But if such is going to occur, it is probably going to happen this year or next.

Senator **Pressler**. I think one thing that has come through from the businessman today and Woody Corner's fine comment that rather than just fuss with the code and change some parts of it, it is better almost to leave it as it is so people can know what it is. With a new tax bill every year and with the IRS implementing regulations almost unsupervised, things have tended to remain fairly confused.

Actually Senator Dole had a number of ideas to close some tax loop holes to try to collect $8 to $10 billion more revenue. The IRS issued recordkeeping regulations for business vehicles, but this regulation will only raise about $100 million, if that, and it will cost small business and agriculture billions to carry out, and I have joined in legislation to repeal it. And it will be repealed.

Dr. **Lein**. Senator, this may be indicative of a problem we sometimes have in lots of environments. If in fact there is a problem, address the problem, but address it specifically and directly where the problem is rather than trying to radically impact upon 100 percent of the population. If 5 percent are abusers or 15, I don't know what the number is, address the problem directly.

That is a good illustration of a system that has occasionally "gone crazy."

Senator **Pressler**. I agree completely.

There is a perceived concept about our tax code favors big business and giant corporations as opposed to small business or small farmers. Of course, it takes a mixture in our business communities. I mean there are certain types of businesses that build automobiles that have to be big businesses, and there are certain types of businesses which must, for instance compete with the Japanese that must be bigger corporations. But the bulk of our employment in this country comes from small business, and there is a perception that our tax laws favor big business over small.

Do any of you want to volunteer any comments on that?

Dr. **Lein**. I happen to be on the board of directors for what I would consider to be a large company, Albertson's Food Chain. I am also intimately involved in a small company in Rapid City. I think it is probably helpful for people in our society to realize the relative level of importance of small business in America.

Today small businesses in the United States account for 97 percent of all nonfarm businesses, for nearly one-half of the Nation's gross national product and nearly three-fifths of all nonfarm employment. And today over 100 million Americans own, work for, or are supported by small businesses.

Now transposing that into something we understand in South Dakota, by definition we don't have very many big businesses in our State because one of the criteria that we are focusing on is having fewer than 500 employees. In South Dakota, we have a population of about 690,000 people, and have over 35,000 small businesses. While those small businesses are an extremely important sector of our economy, it is generally not well organized as a lobbying force.

I guess if there is any disadvantage in Washington as it relates to large businesses versus small businesses, is that the larger corporations can better afford to address some of the broad-based issues in a more orderly fashion through their associations and through their legal departments than can the multitude of very small businesses.

Mr. **Adelstein**. My only comment on that is I think there is more equality than is perceived. The perceived inequality I think is what leads to some of the attempts to remove employer provided fringe benefits. For some reason someone somewhere assumes that these benefits only accrue to employees in large firms. Whether they be health insurance premiums or group term life insurance or education, these really come into companies as small as mine. Their removal acts as a disincentive to performance.

If, once again, we feel that the tax code has as one of its purposes effective operation of business, then surely the removal of these sorts of fringes and their limitation and control and the disincentive to efficiency should be considered.

Senator **Pressler**. I would like to pursue that a little bit because I have been fascinated with this struggle. It seems to me that if we do start taxing fringe benefits, we are going to have a terribly difficult time in reporting them in many instances, plus the Government will have to provide them in some other instances, which will be bad. That is true of medical benefits and so forth.

But I am troubled because in many of these jobs for large corporations around Washington the perks become almost as important as the salary. You can cite examples of college professors and their children getting free tuition. Is that taxable income? A farmer has a family working for him and he gives them room and board and meals. Is that taxable income? Or on a bigger scale airlines giving employees passes to fly. Is that taxable income?

To get all that reported would be a very cumbersome thing. Generally speaking, the benefits given are not the same as direct income. But yet you have another person who works on a straight salary and takes the pay check home with the income taxes taken out.

I think there is kind of a growing feeling that some of these large corporations which have such visible perks will probably say we don't pay you such a high salary, but you get a car, et cetera, et cetera. It is becoming an increasing dilemma.

Now Senator Packwood, chairman of the Finance Committee says that he doesn't want—well, first of all, he doesn't want to have a tax bill this year because he feels that changing this whole thing again is going to be a great burden to the business community and to individuals. But, No. 2, he doesn't want to begin taxing fringe benefits because he says if those fringe benefits are taxed they probably won't be given and just to get them all reported would be very expensive.

Mr. **Adelstein**. I think that you have really hit it. First of all, if we will agree that in America that we have the finest provision, the highest quality of goods and services anywhere in the world for the dollar spent, and we call it the standard of living. That is what we like to call it. Let's look at the examples that you gave.

If college professors on some campuses are allowed to send their children to that campus tuition free, that means that they can serve on that campus at a lesser cost than elsewhere. As a consequence, we are able to have quality professors in many private universities who otherwise would not have them. That is an incentive. And what the provision in the society, what we receive in terms of quality education far surpasses the few dollars that might be collected in taxes.

If executives in corporations, if their perks result in a more effective management of that corporation's affairs and the provision of the goods and services from that corporation that everyone else benefits in, then the society in general and the earning public that pay the other taxes gets the benefits.

Let's take very briefly dependent care services and reimbursement, which I am very familiar with in my company. If we didn't provide that to our employees, we would probably have to pay them more, (a) and, (b) we would lose the attention toward health care costs which are practically unmanageable anyway, but the attention to health care costs that comes from a corporate level and from a sharing in those costs.

In other words, I think that practically every benefit that you listed in there, and that was an excellent list, whether we talk about airlines services, if they are not provided as fringe benefits, then the cost to the consuming public is increased and the revenue to the Government is negligible in comparison to the cost savings overall which result in a sense profits or other taxes.

Senator **Pressler**. I might ask a final question and then see if my colleages have a question for you.

The argument has been made that sometimes tax incentives get money in the wrong places and sometimes in the right places. I think it has been said in many of our big cities there has been an overbuilding of condominium apartments and office buildings sometimes which are built for the tax shelter purpose and not for the real purpose.

Some advocates of a pure flat rate tax say that capital will find its way to the most profitable and the most needed areas without a tax system to guide or encourage it. Do you in general agree with that?

Mr. **Corner**. Well, I think you are going to eliminate a lot of development by these people that are into the limited partnership because I think that now becomes—all the limited partners on one of these proposals becomes all full risk. They are going to be responsible, the limited partners are in this new proposal where the way it is now they are not. So I think that is going to make a lot of difference in your development by these people. In fact, they might quit it. I wouldn't want to go into a deal all risk against the way it is now.

Dr. **Lein**. I tend to concur.

Senator **Pressler**. I might also add that someone mentioned industrial revenue bonds. We are operating with a hugh deficit down in Washington and there is a need to reduce spending. I voted for the across-the-board freeze to treat all the departments of Government the same.

The question of industrial revenue bonds and the various municipal bonds, is receiving a great deal of debate in a time when many States are operating with surpluses and the Federal Government with its deficits is essentially giving up a lot of revenue. There is a lot of economic activity in our States for which there is not revenue being generated.

Chuck, I think you gave a great free enterprise speech, but you said that you wanted to retain the industrial development bonds.

Dr. **Lein**. No, I didn't.

Mr. **Adelstein**. Woody and I did.

Mr. **Corner**. I did.

Senator **Pressler**. Oh, I see. OK.

Dr. **Lein**. This probably exemplifies that if you get three people together you will have three opinions. I tend to disagree with my colleagues on this issue. I think that there have been some flagrant abuses of the original philosophical foundation for tax-free municipal bonds. As the result we have created some inequities at the local level within some industries, as a result of some having available or taking advantage of tax free municipal bond opportunities while their counterparts may, in fact, have had to obtain financing through conventional sources.

And these guys should speak to that.

Mr. **Adelstein**. I believe, as Woody testified so clearly, that the industrial development bonds attract capital to areas like Pendington County, like Lawrence County and like Butte County that would not otherwise be available.

I believe in terms of our desire to decentralize that this is a worthwhile endeavor, and once again the industrial development bonds provide for the construction and operations of businesses which in turn generate income taxes. I think they are essential to overall economic growth, and economic growth results in increased income taxes because of increased economic activity.

Frankly, we are talking in South Dakota, and I think in South Dakota it would be a very serious error to eliminate them, I really do.

Senator **Pressler**. OK. We have one question here.

Mr. **Hudson**. Under current law, as you may know, businesses are allowed to direct expense or writeoff up to only $5,000 worth of depreciable property in a given year. Do any of you make use of that option, and if it were taken away would it affect you? This allows for direct expensing of up to $5,000 of equipment.

Let me broaden the question then. Would you favor direct expensing as a different means of taking depreciation on property?

Mr. **Adelstein**. What sort of property are you referring to because we can depreciate more than $5,000. Are you familiar with that, Woody?

Mr. **Corner**. Isn't that in reverse? I thought it was $10,000 now and it was going to $5,000.

Mr. **Hudson**. No, it is $5,000.

Mr. **Corner**. Five and it is going to 10?

Mr. **Hudson**. It was supposed to go to 10.

Mr. **Corner**. I don't think that is that big an item.

Dr. **Lein**. Only expensing.

Mr. **Hudson**. Right. Well, I think that answers the question.

Senator **Pressler**. Well, I want to thank this panel very much. We may have some additional questions to submit to you in writing for the record.

Woody, do you have a comment?

Mr. **Corner**. Yes. In President Reagan's speech a week ago he mentioned that within 2 or 3 weeks he was going to have his own tax reform submitted to the House and the Senate. Have you seen that? Is that going to follow along the lines of the Treasury Department or is that going to be his own proposal?

Senator **Pressler**. Well, I am fearful it will be a new one because we have a new Secretary of the Treasury since the last Treasury plan was submitted.

I am moving in the direction that if we are going to just reshuffle the cards, as these plans seem to do in my mind, and that is what I have been hearing from businessmen and farmers across the State, that we might as well keep things clear rather than changing them every year. But we have not yet seen his. The new Treasury proposal may be an effort for more of a direct flat tax, I don't know. Secretary Baker having replaced Secretary Regan, it could be that there will be a change.

Well, I thank this panel very much, and I shall call forward the next panel.

We have Leo Herdina, general manager of the Black Hills Milk Producers, Rapid City; Keith Crew from Philip, SD, a rancher, Ken Wetz, the mayor of Newell and Lawrence Brown from Buffalo. We welcome you here today.

We will have one more panel following this panel.

Gentlemen, we thank you very much for being here.

Lawrence, I might call upon your first, if that is all right. You can take your time there if you are not quite ready.

Mr. **Brown**. OK. Could I ask one of the other fellows to begin.

Senator **Pressler**. Ken, may we hear from you first.

STATEMENT OF HON. KENNETH WETZ, MAYOR OF NEWELL, OWNER OF THE BLACK HILLS HONEY CO. AND MANAGER OF THE BUTTE ELECTRIC COOPERATIVE, INC.

Mayor **Wetz**. I think that we all realize that the income tax law has always been one of the most complicated and unpopular laws in this country. But I believe that most of us patriotic Americans realize that we must pay a price for our freedom.

I am truely glad that we not only have the opportunity to pay taxes, but that we also have the chance to speak freely to help change the tax laws and to make them more fair and easier to understand.

In analyzing the three proposals, I think each plan has some good points and bad points that would affect small businesses.

I would like to point out some of the proposals that would generally, I believe, have a positive effect and those that would have an adverse effect on small businesses and the economy of America, especially rural small town America which I represent.

First, in the area of tax rates, I cannot support any change in the tax laws that allows the rich to pay less while the same number of dollars would be collected from the taxpayers.

We all know that the difference would be paid by the middle income wage earners and the small businesses that shoulder the lion's share of the burden today. Any proposal to change the number of rate brackets for tax rates should be thoroughly analyzed so that the ability to pay them is not significantly altered.

The sponsors of the three tax proposals have stated that their plans will not significantly change the distribution of tax burdens by income class. That is where the problem lies. The 50 percent bracket is not bad. Elimination of loop holes so the high income groups pay a proportionate share will make income taxes more fair.

Elimination of the higher tax rate brackets will only make legal what the rich have been doing and would perpetuate the unfair burden on middle income wage earners and small businesses.

The personal exemptions and zero bracket amounts for all three proposals are good. Low income families and large families will spend virtually all of their income for necessities and some quality of life items that they can afford. Their money will be spent so that small businesses can try to earn profits and pay income taxes and the struggling large and low-income families will get the relief and the incentive that they need to become productive members of our society.

Significant changes in the interest expense deductions and depreciation could have severe impact on small businesses and agriculture. The deductions are used by small businesses to replace and expand or improve. Removal of this incentive would encourage many small operators to make do with what they have and not try to offer new products or new services that small towns, such as Newell, SD, need and the consumers want.

A stagnation of the business community in a small town tends to cause it to die. We need legislation that encourages our businesses to grow so that our citizens can be provided with services such as adequate water and waste disposal systems and recreational opportunities such as those that our big city cousins have enjoyed for years.

The interest expense deduction would be virtually eliminated under the Bradley-Gephardt and Kemp-Kasten proposals. This would, I believe, discourage consumer spending and the major brunt of that effect would be borne by small businesses.

Additionally, the attractiveness of small business expansion with borrowed money would be lost and this would lessen spending opportunities in small towns and adversely affect lending institutions as well.

The corporate tax rate is another area where small businesses pay the price while large corporations may even see a decrease in the amount of taxes paid. This, along with the interest and depreciation changes would raise drastically the taxes paid by small businesses such as my own.

One of the reasons for reforming the income tax laws is to simplify the system, but these proposals would not simplify tax returns for those who do not itemize and complexity is added through indexing of interest income, interest deductions, inventory values, capital gains and depreciation.

Major changes would not necessarily be progress if we allow the rich to pay lower taxes while middle income wage earners and small businesses pay more. The complete overhaul of the system may not even be needed if we are not going to simplify the system or if we inhibit the economic progress of most businesses in our small towns.

Thank you.

[The prepared statement of Mayor Newell follows:]

STATEMENT BY
KENNETH WETZ, MAYOR - NEWELL, SOUTH DAKOTA
OWNER - BLACK HILLS HONEY COMPANY
MEMBER SERVICES MANAGER - BUTTE ELECTRIC COOPERATIVE, INC.

818 DARTMOUTH, NEWELL, SOUTH DAKOTA 57760
BEFORE U.S. SENATE SMALL BUSINESS COMMITTEE
FEBRUARY 14, 1985

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The sponsors of the three tax proposals have stated that their plans will not significantly change the distribution of tax burdens by income class. That is where the problem lies. The 50% bracket is not bad. Elimination of loopholes so the high income groups pay a proportionate share will make income taxes more fair. Elimination of the higher tax rate brackets will only make legal what the rich have been doing and would perpetuate the unfair burden on middle income wage earners and small businesses.

The personal exemptions and zero bracket amounts for all three proposals are good. Low income families and large families will spend virtually all of their income for necessities and some "quality of life" items that they can afford. Their money will be spent so that small businesses can try to earn profits and pay income taxes and the struggling large and low income families will get the relief and incentive they need to become productive members of our society.

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Senator **Pressler**. Thank you very much, Ken.

Lawrence Brown, we will hear from you.

STATEMENT OF LAWRENCE BROWN, RANCHER, BUFFALO, SD

Mr. **Brown**. Well, thank you, Larry.

I appreciate the opportunity to appear on this panel. I guess the things I have to say are ramifications of tax law, my thoughts.

First, I am not a tax expert and can find much confusion in 1040 tax forms and all the simplified versions thereof without detailed study of several new tax law proposals, and since I hire my tax work down, I first contacted my accountant for help with these new tax law proposals only to find they have little to offer in the way of specific information.

So I can only offer a few general thoughts on what some areas of tax law have done to and for us in the past and may do in the future. A flat and moderate rate of tax would look good to this taxpayer if everyone can be treated alike.

The first to come to mind is capital gains exclusion. Certainly the industry of agriculture has been blessed with non-ag investors because of capital gains exclusions on farmland and livestock. But the prosperity the drug store cowboy or investor has brought to the livestock industry has also generated a wave of inflation for our industry that is presently tumbling down around our ears.

If agriculture and those of us in the industry can attract the city investor's dollar on our own merit, then well and good. But if that dollar comes to us through some special tax privilege, the long range effect is a proverbial sell-out for 30 pieces of silver and the consequences thereof.

During the decades of the 1950's, 1960's and 1970's agriculture enjoyed a prosperity far in excess of its ability to produce. This was due to the capital gains and investment credits that had lured outside capital into the industry to pump land values up near double their rate of productivity.

Now with nearly one-third of the Nation's farmers and ranchers teetering on the edge of bankruptcy, do we give the outside investors a tax advantage to accelerate the corporate take-over, or do we eliminate tax advantages and keep the industry in the hands of ag people?

Nearly every session of South Dakota's Legislature has had legislation introduced to restrict or further limit corporate farming. Isn't it an inconsistency to offer the corporate investor a Federal tax advantage to attract that dollar to agriculture and then have States pass laws or consider laws to restrict that investment?

Investment credit is another tax loophole of questionable value to the user of equipment. Many purchases of equipment have been made ahead of a real need in order to take advantage of investment credit. This only inflates the overall price of equipment and puts the user deeper in debt. This may have been an advantage to a manufacturer to sell more equipment and a banker to loan more money on it. But the farmer user often wound up carrying an extra debt burden to reap a small tax advantage.

Income averaging has been a benefit to farmers because farm income is erratic by nature, with good income some years and poor income others. In bracket tax plans averaging would be an advantage, but flat rate taxation would eliminate that advantage as well. If everyone in all industry were taxed on the same rate and had the same exclusions, then farmers should be able to get along in a system like that.

A point also needs to be made on the reverse side of tax advantage, and that is the IRS requirement that all farmers and small business people keep hour-by-hour records of the movement of their business vehicles in the pursuit of that business.

Recordkeeping to that extent is a burden no segment of business should be subject to and an annoyance that makes business people start thinking of starting to operate on an out-of-pocket cash basis that gets away from the whole record and tax system.

In conclusion, agriculture in general is in deep financial trouble, and until we can reach a point where our product will turn a profit, no income tax advantage will do us much good.

Thank you.

[The prepared statement of Mr. Brown follows:]

Statement of Lawrence Brown
Box 27
Buffalo, South Dakota 57720
Small Business Hearing
Rapid City, South Dakota
February 14, 1985

RAMIFICATION OF TAX LAW, MY THOUGHTS

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During the decades of the 50's, 60's, and 70's, agriculture enjoyed a prosperity far in excess of its ability to produce. This was due to capital gains and investment credits that lured outside capital into the industry to pump land values up near double their rate of productivity. Now with merely one-third of the nation's farmers and ranchers teetering on the edge of bankruptcy, do we give the outside investors a tax advantage to accelerate the corporate take-over or do we eliminate tax advantages and keep the industry in the hands of ag people?

Nearly every session of the South Dakota Legislature has legislation introduced to restrict or further limit corporate farming. Isn't it an inconsistency to offer the corporate investor a federal tax advantage to attract that dollar to agriculture and then have states pass laws or consider laws to restrict that investment?

Investment credit is another tax loophole of questionable value to the user of equipment. Many purchases of equipment have been made ahead of a real need in order to take advantage of investment credit. This only inflates the overall price of equipment and puts the user deeper in debt. This may have been an advantage to a manufacturer to sell more equipment and a banker to loan more money on it, but the farmer user often wound up carrying an extra debt burden to reap a small tax advantage.

Income averaging has been a benefit to farmers because farm income is erratic by nature, with good income some years and poor income others. In bracket tax plans, averaging would be an advantage but flat rate taxation would eliminate that advantage as well. If everyone in all industry were taxed the same rate and had the same exclusions, then farmers should be able to get along in a system like that.

A point also needs to be made on the reverse side of tax advantage, and that is the IRS requirement that all farmers and small business people keep hour by hour records on the movement of their business vehicles in the pursuit of that business. Record keeping to that extent is a burden no segment of business should be subject to, and an annoyance that makes business people start thinking of starting to operate on an out of pocket cash basis that gets away from the whole record and tax system.

In conclusion, agriculture in general is in deep financial trouble, and until we reach a point where our product will turn a profit, no income tax advantage will do us much good.

Senator **Pressler**. Next I think I will call on Leo Herdina, the General Manager of the Black Hills Milk Producers.

Leo, we welcome you here and look forward to your testimony.

TESTIMONY OF LEO HERDINA, GENERAL MANAGER, BLACK HILLS MILK PRODUCERS, RAPID CITY, SD

Mr. **Herdina**. Thank you, Senator.

My overview of this committee hearing today will be limited to that of agriculture. As these three proposals would affect agriculture on the farm. So the four points I would like to cover will be directed in the agriculture vein.

This testimony is in response to the flat tax plan of the Treasury Department and others. In reviewing the three major plans put forward, there are several serious concerns that small business operations should be aware of. As an operator of an agricultural small business, the following areas of these flat tax proposals would further weaken an already sick agriculture in this country.

Item 1, depreciation. Except for the Kemp-Kasten plan, there would be sharp reduction in depreciation deductions. This would not be an improvement for many in agriculture.

Item 2, investment tax credit. With all three plans doing away with these credits, it will adversely affect many small business operations. Many times this credit assists in making a decision of purchasing equipment.

Item 3, capital gains and losses. There would be considerable changes in this area. Many of these changes may not have a lot of impact on many small businesses.

Item 4, taxable income. The big question and concern has to be in this area. I am of the belief that with the changes in the depreciation and investment tax credits the taxable income must go up. Even with all of these plans showing a smaller percentage of tax rates, many operators would experience paying more in tax than they do under the present law.

The sad fact today is that many agricultural cattlemen, dairymen, and farmers in general pay no tax at all, the reason being that after taking their deductions they have no income left to pay tax on.

Thank you.

[The prepared statement of Mr. Herdina follows:]

Black Hills Milk Producers
1130 East St. James P. O. Box 2084 Area Code 605 Phone 342-3780
Rapid City, South Dakota 57709

STATEMENT BY

LEO HERDINA, GENERAL MANAGER

BLACK HILLS MILK PRODUCERS
1130 E. ST. JAMES ST.
RAPID CITY, SOUTH DAKOTA

BEFORE SUBCOMMITTEE ON

U. S. SENATE SMALL BUSINESS COMMITTEE

FEBRUARY 14, 1985

This testimony is in response to the "flat tax" plan of the Treasury Department and others. In reviewing the three major plans put forward, there are several serious concerns small business operations should be aware of. As an operater of an agricultural small business, the following areas of these "flat tax" proposals will furthur weaken an already sick agriculture in this country.

1. Depreciation. Except for the Kemp-Kasten plan, there would be sharp reduction in depreciation deductions. This would not be an improvement for many in agriculture.

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3. Capital Gains and Losses. There would be considerable changes in this area. Much of these changes may not have alot of impact on many small businesses.

4. Taxable Income. The big question and concern has to be in this area. I'm of the belief that with the changes in depreciation and investment tax credits, the taxable income must go up. Even with all of these plans showing smaller percentages of tax rates, many operators would experience paying more in tax than they do under the present law.

The sad fact today is that many agricultural cattlemen, dairymen, and farmers in general pay no tax at all...the reason being, that after taking their deductions they have on taxable income left to pay tax on.

Senator **Pressler**. Thank you very much.

Leo, I think I can say that you grew up in my hometown of Humboldt, am I not correct?

Mr. **Herdina**. Right.

Senator **Pressler**. And your Dad ran our dairy there for many years, and I appreciate that.

Next we will call on Keith Crew from Philip, SD, a rancher and owner of Circle 10 Campground near Interior.

Keith.

STATEMENT OF KEITH L. CREW, RANCHER AND BUSINESSMAN AND OWNER OF THE CIRCLE 10 CAMPGROUND NEAR INTERIOR

Mr. **Crew**. Senator Pressler and members of the committee, my name is Keith Crew. My wife and I live on a ranch near Philip and we are fortunate to have our two sons at home with us.

In 1951 the highway department opened a road to the Badlands National Park directly through the middle of our ranch. In 1963 we restored and opened to the public an original set of homestead buildings, including a sod dwelling. This historic site has become one of the major tourist attractions in western South Dakota.

In 1973 we opened a filling station and have expanded it to a minimart with exceptionally good summertime business, and then in 1977 my family and I formed a corporation and purchased the Circle 10 Campground. It is also on the ranch.

We are in no way tax experts, but through the course of a year's time we are involved with decisions based on involving many of the Federal income tax laws. I have studied the information that you sent me and for the most part I have no problems with the proposals offered by the U.S. Treasury Department.

It is my feeling that we should have taxes that are fair to everyone, no matter what their income or their profession. This would mean that taxes be ones that we can all understand, taxes without loopholes, taxes based on earnings after expenses and allowable deductions and depreciation. I feel that it is very necessary to eliminate some of the tax-free income and tax-free fringe benefits and tax shelters. The continuation of these benefits only shift the tax burdens onto the ones of us who do not qualify for the above.

All three of the proposals indicate a maximum tax rate much below the 50 percent on maximum earnings. This is fine if the revenue derived will be sufficient. I do feel that a tax rate schedule could be set up on a mathematical formula so that it would be a smooth curve rather than the graduated jumps proposed by all three.

With extensive use of the computer today this would be no problem at all and probably would be much easier to calculate.

Income averaging is a very fair way to deal with extreme fluctuations in business income, especially on the farms and ranches.

I agree with the Treasury plan to retain this provision. I am not clear what exactly is proposed for long-term capital gains, but feel it has been a very workable element in the past for the individual.

I would like to add that I agree with Larry that I think that is why our land is so high is because of outside investments because of capital gains.

As for repealing the investment credit, I have mixed emotions. Sometimes it is a little incentive that causes one to purchase a new machine or a building. Without it there would be some reduction in large purchases.

The new tax rate proposed for business by the Treasury Department and the Bradley-Gephardt proposals are much too high for the little business person. It should be left as a graduated tax as it is now. Indexing depreciable items for inflation has the sound of a lot more regulations and confusion, which is just what we do not need. One other thing we do not need is the IRS ruling requiring farmers to keep log books on vehicles.

I am in favor of the Treasury Department recommendation for business deductions such as travel, entertainment, and food and lodging. I also feel that giving employees benefits under some of the present tax shelters should be stopped.

If there is any one thing that the Congress might do to strengthen our country, promote jobs and keep our money home it would be in the form of legislation to control our balance of trade with foreign countries. If we do not do something to protect ourselves, we as a Nation will soon be in the same shape as our farmers and ranchers are today.

They are guilty of only one thing, spending more than they make. Isn't that just exactly what our country is doing today? The excess spending within this country is a problem that should be corrected, but the money is still here being used again by someone. But when it is used to purchase a product from a foreign country, it is gone forever.

I would like to propose a 5- or 10-percent additional income tax on profits derived from the sale of products obtained from a foreign country. This would help agriculture, the textile industry, most all manufacturing and a host of other industries.

If we can put our own people back to work in our own factories producing our own products, there will be many more dollars in the economy to purchase agricultural products, homes and other gadgets. This would generate an unbelievable amount of income that could then be returned to the U. S. Treasury through our tax system.

Senator Pressler, I thank you for the opportunity of appearing before your committee.

[The prepared statement of Mr. Crew follows:]

STATMENT BY
KEITH L CREW, RANCHER AND BUSINESSMAN
BEFORE SUBCOMMITTEE ON TAXATION
SENATE SMALL BUSINESS COMMITTEE
RAPID CITY S. D.
FEBRUARY 14, 1985

SENATOR LARRY PRESSLER AND
MEMBERS OF THE
COMMITTEE ON SMALL BUSINESS

My name is Keith Crew. My wife and I live on our ranch near Philip, S.D. We are fortunate to also have our two sons and their wives on the ranch with us.

In 1951 the Highway Department opened a road to the Badlands National Park directly through the middle of our ranch. In 1963 we restored and opened to the public an original sod dwelling. This historic site has become one of the major tourist attractions in western South Dakota. In 1973 we opened a filling station an have expanded it to a mini mart with exceptionaly good summer time business. In 1977 my family and I formed a corporation and purchased the Circle (10) Campground Inc. It is also on the ranch.

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All three of the proposals indicate a maximum tax rate much below the present 50% on maximum earnings. This is fine if the revenue derived will be sufficent. I do feel that a tax rate schedual could be set up on a mathamatical formula so that it would be a smooth curve rather than the graduated jumps proposed. With the extensive use of the computer today this would be no problem an probably would be much easier to calculate.

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The new tax rates proposed for businesses by the Treasury Dept and Bradley-Gephardt are much to high for the little business person. It should be left a graduate tax as it now is. Indexing depreciable items for inflation has the sound of a lot more regulations and confusion which is just what we do not need. One other thing we do not need is the new IRS ruling requiring farmers to keep a log book on vehicles.

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If there is any one thing the congress might do to strenghten our country, promote jobs, and keep our money home it would be in the form of legislation to control our balance of trade with foreign countries. If we do not do something to protect ourselves we as a nation will soon be in the same shape as many of our farmers and ranchers are today. They are guilty of only one thing, spending more than they make. Isn't this just exactly what is happening to our country. The excess spending within this country is a problem that should be corrected but the money is still here and being used again by someone, but when it is use to purchase a product from a foreign country it is gone forever. I would like to propose a 5% or 10% additional income tax on profits derived from the sale of any product obtained from a foreign country. This would help agriculture, the textile industry, most all manufacturing and a host of other industries. If we can put our people back to work in our own factories, producing our own products, there will be many more dollars in the economy to purchase agriculture products, homes, and gadgets. This would generate an unbelivable amount of income that could then be returned to the U. S. Treasury through our tax system.

Senator Pressler, I thank you for the opportunity to appear before your committee.

Keith L. Crew
Rt 1 Box 51
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Senator **Pressler**. Well, thank you all very much for your testimony, excellent testimony.

Let me ask a question. Many of you mentioned in your testimony that nonfarm deductions were doing a lot of damage to agriculture, that is investment from the outside that is really not by people who are tilling the soil or running the ranch, but invested to take losses or something of that sort.

I think, Lawrence, you suggested that that ran up the price of farmland. The dilemma you get into and, indeed, I am for ending that, but the dilemma you get into very quickly is what do you do about the case of the man who is working part time and living on a farm trying to get started? He would be deducting farm losses or using depreciation on his farm against nonfarm income.

Or what do you do about the rancher or farmer who wants to have some investment capital and can't borrow it but needs a partner who has got some money?

And then the final dilemma in writing that piece of legislation, which I would support incidentally if we could figure out a way to do it, is the widow and there are three children in the family and two of them live in town and have other jobs but yet they would have income from the farm and they would be able to participate in the tax advantages or disadvantages of that farm.

So how do we sort out the true farm or ranch investor and how do we keep some of this outside abuses of writing off agriculture by some of these large corporations that are breaking up so much of the rangeland in the West?

Mr. **Brown**. Well, I don't know as they would need to be sorted out or sorted off, as you say. The point I made in my commentary here was that we would welcome capital from outside of the farm, but outside of the farming industry, and there is certainly nothing wrong with that. If the man in town wants to go farming or wants to invest in some portion of a farm enterprise, that is fine and we would welcome that investment. But it shouldn't be made through a tax advantage. That is the point I am trying to make, is that why should we seek dollars from outside of agriculture through special tax incentives that bring this outside investment in.

If your city fellow feels that he wants to go farming, why that is fine and dandy and we welcome him to the industry, but the advantages is the point. I don't think there needs to be any sorting out of this thing. I think that that would be done just on the person's own opinions.

Senator **Pressler**. Yes, Leo.

Mr. **Herdina**. If I could, Senator, I would like to comment on that. In looking around the audience I do not see my doctor here. So I will use him as an example. [Laughter.]

I think to answer part of your question, if he would desire to make investments from his profession in agriculture, first, maybe the proceeds or income from his profession should be taxed at that level before he makes that money available as is indicated here in many cases to invest in agricultural enterprises that may be tax sheltered with losses. So that might be a start. How it would be written would be a very complex thing to get to graduations of illustrations that you have used.

Senator PRESSLER. Ken, you very eloquently stated that we all know the difference would be paid by the middle income wage earners and the small businesses that shoulder the lion's share of the burden today.

They have their income taxes taken out of their pay, they don't have any deductions or exemptions and they haven't been able to invest.

Do you feel that there is a bias toward unearned income in our tax structure today as opposed to earned income?

Mayor WETZ. Let me start by saying that when I was invited to appear before this committee I thought this was the greatest thing I had ever heard of to revise the income tax laws. And the more I studied the proposals, the more I think that it took us a long time to develop the system that we have, and if we make changes that are going to adversely affect these people that are, as you have said and I previously stated, are paying their fair share already, and true, they don't have additional loopholes. They are the people that are struggling to make a living.

In our small towns we don't have large corporations. We have a few small corporations, but they are usually family corporations. If we increase their tax burden, I think we are going to see the loss of some of those in our small towns, and we are already struggling for survival in rural America.

That is not only as these gentlemen around me have said on the farms, but in our small towns. When our farmers and rancher friends are hurting, so are our small businesses in our small towns. We feel that effect, it maybe will take a few days longer, but we feel the effects just as real.

Senator PRESSLER. Do you as mayor of a town, do you have any strong feelings about the industrial revenue bond issue and the municipal bond issue in terms of disallowing the tax exemption in terms of Federal taxation?

Mayor WETZ. Well, I have worked with the Northern Hills Community Development Corp., which is the nonprofit group to try to promote development in the Northern Black Hills, and as a representative of that group I think we need to keep those kinds of opportunities available.

It is really tough to attract new businesses to most of the towns in the Northern Hills. We don't have the capital to expand and assist those businesses without some types of tax advantages such as industrial revenue bonds and so on.

Senator PRESSLER. Do either of my colleagues have a question?

Mr. WALSH. I would like to examine the capital gains issue just a little bit. The Treasury Department proposal would index the basis upon which capital gains was calculated. The current maximum rate on capital gains would be 20 percent. If the Treasury Department proposal was passed, the rate would be 35 percent, but on a smaller amount. It would calculate out that attributable to inflation.

I did some back-of-the-envelope calculations and it works out that if you had a gain which was 40 percent or more attributable to inflation, you would probably be better off with the Reagan administration's proposal.

I just wonder from your own experience whether you might feel you would be better off with that Treasury Department proposal or current law, and that is to anyone who may want to address the question.

Senator PRESSLER. Any volunteers on that? [Laughter.]

Mr. BROWN. I am not sure that I am qualified to answer that question as it was stated. I think if the whole tax structure were lowered, if we had a flat and uniform tax, it would pretty much eliminate the need for the capital gains situation. And without a detailed study of it, I guess that is the best answer I could give you. Maybe one of the other fellows has a better idea.

Senator PRESSLER. One question I have been wanting to ask, and I like to ask this question, and it is none of my business if people don't want to answer, but do any of you prepare your own taxes without assistance?

Mayor WETZ. My wife and I do.

Senator PRESSLER. Well, you are very brave people. [Laughter.]

Yesterday we found that hardly anybody prepared their own taxes, which is kind of a reflection on the system I suppose because a system of taxes should be such that people can understand it. Of course you get into some of these complicated business situations and some of the complications are in the business itself and not necessarily in the tax reporting.

I wanted to ask a question of Keith Crew. I think you have got a tourism industry item there. I don't know quite what the capitalization of it is or if it requires intense capitalization. It is said that the service industry, the tourist industry, is not able to take advantage of depreciation and of inventory and so forth because they are a lower capitalized industry. It would depend on the kind of tourist industry we are talking about or the kinds of tourists that we have. But is tourism treated fairly or about the same?

Mr. CREW. I see no difference. We have taken advantage of it, the depreciation on buildings and various things within the business. Yes, I think we are fair and I see no reason why not.

As far as the inventory that you are talking about and so forth, of course it goes up and down and we like to get it down in the wintertime so we are not paying interest on it, but we don't always, and it all works out. I think that aspect is okay.

Senator PRESSLER. Well, I think that this panel has presented some excellent grass roots type of testimony from what our people think of the tax code. I have gathered many ideas from this and we will make your statements part of the record. We thank you very much.

Let me say to any persons who have come in late that is you have a specific case, I will be happy afterwards to meet with different groups. But if you do have a case and want to start telling one of my case workers about it, we could perhaps save some time.

Let us go on to the next panel.

I will call forward Kay Riordan-Steuerwald of Rapid City, the head of The Mountain Co. and a member of the Senate Commerce Committee Tourism Advisory Board, one of the most prominent leaders in the South Dakota tourism industry who recently received the Ben Black Elk Award from the State tourism department, also Milo Rypkema of Rapid City, the owner of the Dodge

Town automobile dealership and the owner of the Mount Rushmore Angus Ranch. Also we will call forward Art Jones of Belle Fourche who is recently retired as president of Tri-State National Bank in Belle Fourche and Tom Lane the president of Kluthe and Lane Insurance Co.

If we could have all of you please come forward.

I guess we are short one.

Kay, why don't you begin. We welcome you here and we thank you very much for taking the time.

STATEMENT OF KAY RIORDAN-STEUERWALD, OWNER OF THE MOUNTAIN COMPANY AND MEMBER OF THE SENATE COMMERCE COMMITTEE TOURISM ADVISORY BOARD

Ms. Riordan-Steuerwald. Thank you, Senator Pressler, and I hope you convey our thanks to Senator Weicker and all the other members of the committee that are not here today for choosing South Dakota as one of the States that you are conducting these hearings in. I think there are four States.

Of course, it is very apropos because, as you well know, by Government standards South Dakota is made up entirely of small business people.

I think one of the great shocks I had when I went to Washington representing our State in the White House Conference on Small Business in 1980 was to find out that our Government considered any business with 500 employees and less small business, and I think therein lies quite a bit of our problem.

Main Street U.S.A. are small communities, as we have just listened to our Major of Newell. We are just a forgotten crowd, because when you think that bureaucracy thinks in terms of small businesses being 500 people and less, it is no wonder that some of the problems we have in surviving in our small towns exists.

I have been a small business person in South Dakota for over 40 years. The businesses I have been associated with are all service related businesses, such as hotel, motel, restaurants, an Indian trading post, art galleries and for the past 30 years as a National Park Concessioner at Mount Rushmore National Memorial, as most of you know.

And while I am at that point, I want to touch on what one of the other members gave testimony on, and that is that it seems as though the way Government has grown, I don't know what can be done about it. But using Mount Rushmore as an example, when I started there in 1951 the Government had six employees. In order to run a business there that was required to service the public at that time with approximately 700,000 visitations, it required 35 employees for my company.

Now these 30 years later and three times the visitation, our visitation now is about 2 million 1, which would make it just practically three times, we have exactly three times the employees to run that same type of service business. But the Government has 10 times the employees to maintain their part of Mount Rushmore.

I thought that would be interesting because I think one of the great causes of our deficit is the cost of Government, and I think as tough as it is, I think that it is something that the Congress has to address and it has to be foremost.

As I mentioned, I represented our State in Washington in both 1981 and 1982 in the Small Business Conferences, and we do have a very small voice.

But again thanks to much good work done by such committees as this and the efforts of the Small Business Administration, and I haven't heard anyone address themselves to their feelings about the Small Business Administration. But I think it is the only advocacy in my lifetime that I know of that has given any advice or any representation to the small business person, and I would have great trepidations about seeing the Small Business Administration eliminated in this sweeping wave of saving and economy.

It was amazing in 1980 and what has happened since then. We first went and everyone that was there, which was somewheres close to 10,000 small business people, we had no unity and no organization. And since that time we have the Small Business Legislative Council, we have an organization that sort of acts as an umbrella called Small Business United, and then we have a coalition of many regional small business associations.

I also will say that the Federal Government has enacted legislation within the last 5 years that I feel has been most helpful to the small business entrepreneur, such as the reforms of the subchapter S legislation, the estate tax law, the passage of the Export Trading Company Act, the Prompt Payment Act where the Government has to pay the small business person that has done business with them, and then the greatest of all is the accelerated cost recovery system.

And the possibility that some of these will be repealed makes it very difficult for me to pass judgment on these three flat tax proposals as to what is the best course for the small business person to take. The Kemp-Kasten bill retains ACRS with the other two plans repealing it, and the Bradley-Gephardt allows the deduction of our income taxes and the others do not.

And it was such a dilemma as I was studying this that I decided, as one other gentleman brought out, that I would go and talk to our accountant about it. In fact, I asked him to put a pencil to the Treasury proposal using our company's 1983 tax return as a hypothetical. And using the Treasury's three-bracket system, of 15, 25 and 35, versus the present 14 brackets of 11 to 50 percent, we come up with a 19 percent savings on our tax return.

This was on my individual return, and I am a little ahead, but on the corporate tax where they are using the 33 percent rate for corporations. On my company's 1983 tax return there was a decided saving with the Treasury plan.

These comparisons were only recognizing the Treasury's proposals for rate changes and the repeal of the investment credit. And it must be taken into consideration that our corporation is, you could call it practically an old established firm after 30 years, and we do not have the financing problems as does practically every new small business that has been established in the last 5 years.

So I don't know whether that was a fair equation to come up with or not, but I thought it was interesting.

As for the capital gains, with the original cost of assets used in calculating gains and in these new proposals, the only adjustment being for inflation and taxing that as ordinary income, I could see where this could discourage and significantly change the outlook for a lot of small businesses.

However, I think we all must recognize that tax reform and tax simplification has universal appeal to everyone. It really does. I don't know whether it is the title or whether people are so weary from what you have to go through to enact your tax forms these days. But last Monday morning at my 6:30 toastmaster's club we discussed the pros and cons of these three proposals versus the present system, and it was practically unanimous that tax reform and tax simplification are foremost in everyone's mind. Most of them hadn't studied it and hadn't had the opportunity as I had had from the material that you sent.

But I have such great concern for the people who have recently gone into business, and all the people that I know are in small business, or those that are contemplating it, and the great interest that I have had in young people over the years, I guess I would have to see additional study of these three proposals and the repeal of many of the repeal clauses on any of these three proposals, especially on those issues like ACRS that really give a break to the small business community.

So after all my discussion with as many of these people that I had the opportunity to talk to and reading, I am still in a quandary as to how much advantage. As has been brought out before, there are advantages and disadvantages to all three of the proposals and there are many disadvantages to the present system. I wouldn't be able at this time to pass judgment.

[The prepared statement of Ms. Riordan-Steuerwald follows:]

Statement By: Kay Riordan Steuerwald, President - Mountain Company, Inc.

Mount Rushmore National Memorial - Keystone, S.D. 57751

Before - SUBCOMMITTEE ON U.S. SENATE SMALL BUSINESS COMMITTEE - February 14, 1985.

I have been a small business person in South Dakota for over forty years. The bussinesses I have been associated with are all service related businesses; such as Hotel - Motel - Restaurants - an Indian Trading Post - Art Galleries - and for the past thirty years as a National Park Concessioner at Mount Rushmore National Memorial.

Thank you - Senator Weicker and members of your Committee for choosing South Dakota as one of the states to conduct these Hearings. By government standerds South Dakota is made up entirely of small business people as they consider small business as 500 employees or less.

Having represented our State at the Conferences in Washington both in 1980 and 1982 regarding Small Business, I am very cognizant of the small voice we have had in government rules and regulations. Again thanks to much good work done by your Committee and the efforts of the Small Business Administration — the unification of small business people into the Small Business Legislative Council, Small Business United, and the coalition of regional small business associations, the Federal Government has enacted legislation within the last five years that has been most helpful to small business entrepreneurs, such as the reforms of the Subchapter S legislation, the estate tax law, and the passage of the Export Trading Company Act, the Prompt Payment Act and the Accelerated Cost Recovery System. The possibility that some of these will be repealed makes it very difficult for me to pass judgment on the flat tax proposals as to what is the best course for the small business person to take. The Kemp Kasten Bill retains ACRS with the other two plans repealing it. The Bradley Gephardt allows deduction of Income Taxes and the other two do not.

In reviewing the rate structure of the Treasury's Tax Simplification Plan for individuals, I asked our Accountant to put a pencil to this proposal using my 1983 tax return as a hypothetical. Using the Treasury's three bracket system of 15-25-35% versus the present 14 brackets from 11% to 50%, I came out with a 19% saving on my individual tax return. Again using the Treasury's 33% tax rate for corporations with our company's 1983 tax return, there was a substantial saving to our company with the Treasury's Plan. These comparisons were only recognizing the Treasury's proposal for rate changes and repeal of Investment Credit. It must be taken into consideration that our corporation is an old established firm that does not have financing problems as does practically every new small business established in the past five years.

As for Capital Gains - with the original cost of assets used in calculating gains and the only adjustment being for inflation, and with such gain taxed as ordinary income, this could also discourage and significantly change the outlook for small business.

However, we must all recognise that "tax reform" and "tax simplification" has universal appeal to everyone, including the small business person. At my 6:30 A.M. Toastmaster's Club last Monday morning, we discussed the pros and cons of these three proposals versus the present system, and it was practically unamious that tax reform and tax simplification are foremost in everyone's mind.

With the great concern that I feel for the people who have recently gone into business or are contemplating it, and my great interest in young people, I would like to see additional study of these three proposals, and remove the repeal clause on those issues that have given a break to the small business community.

Thank you

Senator PRESSLER. Kay, I thank you very much for that thoughtful statement.

Milo Rypkema, owner of Dodge Town automobile dealership and owner of Black Angus I believe, not Red Angus. I know they are black.

STATEMENT OF MILO RYPKEMA, OWNER OF DODGE TOWN, INC., AND OWNER OF MOUNT RUSHMORE ANGUS RANCH

Mr. RYPKEMA. Thank you, Senator Pressler, and members of the committee.

I thank you for the opportunity to share with you how the proposed tax changes would affect my personal closed corporation, Dodge Town, Inc.

I think changing the tax regulations might be better entitled "Shifting of Taxes," or "Adding New Taxes."

To me, people pay taxes, not corporations. The Federal Government is the only one that I know that budgets for a deficit spending.

The individual or couple basic tax exemption allowance is out of tune with reality and entirely unrealistic. it would seem a level needs to be set where people would pay no tax until they reached a certain plateau.

Under the proposal, as I understand it, the small businessman would get taxed even more. The proposed changes could cost my corporation, according to my accountant, $9,000 in additional taxes.

Any change in the depreciation allowance must also allow assets to be written off over their useful lives.

Investment tax credit elimination would stagnate our economy and have an adverse effect on those who purchase products offered for sale by the small businessman, further complicating the economic upturn of our national economy.

The changing of the capital gains rule would prevent me from selling my business. I have paid ordinary taxes on retained earnings. I left that retained earnings in my business and it has grown from an establishment that employed 12 people at the beginning to 26 today, and that was by leaving my retained earnings in the business to grow.

If taxed in a different form, it would be almost prohibitive for me to sell my business today.

Health insurance benefits being taxed would cause many to cancel, shifting the expense to others.

Flat corporate taxes higher than the 15 to 18 percent brackets for small business would hurt them immensely. Indexing of tax rates should be retained.

I find it difficult to believe that either the simplified or fair tax can become a reality in our complex society.

The present system is beyond the comprehension of most people, including the IRS. The citizens of this great country are at a very uneasy rationale. Deficit Federal spending is the crux to our taxing problems.

And if I might ad lib, and this isn't in the policy or in my notes, but I think we have three things facing our American public that might be more important than wrestling with what we are talking about today.

No. 1, our Nation needs a farm policy. We have had a Band-Aid package from year to year, at the cry of the people, some of them in need and some of them not, that has really helped the wrong people. We need a policy, good or bad, that they can plan for the future on and we do not have that.

I think that same thing is true for an energy policy for this Nation, because I am a firm believer that the energy that we use today has not hit the high plateau that we are going to pay for and we need a policy, a national energy policy. That might also be true for an industrial policy that relates to what some of them said about taxing other products that come in. It is a complicated thing, but we do not have an industrial policy in this Nation today.

And those three items might be more important than what we are talking about in the proposed tax changes.

[The prepared statement of Mr. Rypkema follows:]

DODGE TOWN INC.

DODGE CARS DODGE TRUCKS

1120 East Omaha Street
Phone 343 - 2896
Rapid City, South Dakota, 57701

February 13, 1985

Senator Larry Pressler
Member, Committee on Small Business
Washington, D. C. 20510

Dear Larry:

I thank you for the opportunity to share with you how the proposed tax changes would affect my personal closed corporation, Dodge Town, Inc.

Changing of tax regulations might be entitled, "Shifting of Taxes" or "Adding New Taxes". To me, people pay taxes, not corporations.

The federal government is the only one I know of that budgets for deficit spending.

The individual or couple basic tax exemption allowance is out of tune with reality and entirely unrealistic. It would seem a level needs to be set where people would pay no tax until they reached that plateau.

Under the proposal, as I understand it, the small business will get taxed even more. The proposed change would cost me an additional $9,000 in taxes.

Any change in depreciation allowances must allow assets to be written off over their useful lives.

Investment tax credit elimination would stagnate our economy and have an adverse effect on those who purchase their products offered for sale by the small businessman, further complicating the economic upturn of our national economy.

The changing of the capital gains rules would prevent me from selling my business. I have already paid ordinary taxes on my retained earnings. Changing this rule would cost me if I were to sell and be double-taxed as ordinary income.

DODGE TOWN INC.

DODGE CARS DODGE TRUCKS

1120 East Omaha Street
Phone 343 - 2896
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Health insurance benefits being taxed would cause many to cancel, shifting the expense to others.

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Indexing of tax rates should be retained.

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The present system is beyond the comprehension of most people, including the IRS. The citizens of this great country are at a very uneasy rationale. Deficit federal spending is the crux to our taxing problem.

Respectfully,

Milo Rypkema
President
DODGE TOWN, INC.

MR/dr

Senator PRESSLER. I thank you very much for that fine statement.

Next I shall call on Tom Lane, the president of Kluthe and Lane Insurance Co. whose late partner was a great friend of mine as well as Tom.

Tom, we thank you for being here.

STATEMENT OF THOMAS E. LANE, PRESIDENT, KLUTHE & LANE INSURANCE—FIRST AMERICAN SYSTEMS, INC.

Mr. LANE. Thank you very much, Senator.

I am president of an insurance agency organization headquartered in Rapid City. The reason I mention this is it is beyond just Kluthe & Lane. We have offices in Sturgis and Mitchell, SD as well as Rapid City, we have an office in Denver, CO and we have an office in Buffalo, WY.

We are independent insurance agents functioning as sales and service offices for a number of different insurance companies. We sell all kinds and all forms of insurance such as commercial property and casualty, automobile, homeowners, life, disability and health insurance for both individuals and groups.

I am of the opinion that the 1984 Tax Reform Act is a lot more taxing than reforming. Although there are many good features to the proposals being presented, I see several areas that will have a particular impact on my industry, and that is why I wanted to explain that I am representing the whole facet of life and health and property insurance.

First, it appears that Universal Life Insurance will continue to receive its favorable tax impact, and this is terribly important for that has become a very popular and necessary life insurance product.

Another item, under the old law group term life insurance in excess of $50,000 provided for retired employees did not result in taxable income to those former workers. But now under the new proposals, any cost of excess coverage over $50,000 is taxable income less any contribution made by that retiree.

Key employees could be damaged when they are provided insurance under a plan that is considered discriminatory. Under such plans the actual full costs of the insurance paid by the employer is included in the employee's income.

All of these items concern me.

As a small business person, I am concerned with some of the expensing provisions. As an example, if we were to buy a new desk or a small computer or typewriter, we could normally recovery that cost over several years or could elect to take the current writeoff on as much as $5,000 of the cost. That amount increased in 1984 to $7,500, but now that additional $2,500 has disappeared and according to the proposals is freezed until 1988. This could have quite an impact on real small offices. The loss of the investment tax credit for property used less than 50 percent of the time in business could have a significant impact on small insurance agencies; autos, computers, trucks, entertainment and recreation property could all be involved.

The recordkeeping necessary with the new proposed law also has a terrible impact on a small one or two-man business. The new law tightens the recordkeeping requirements so much that many small agents will probably get in trouble with the IRS over it.

I am particularly upset that the owners are required to sign a written confirmation that certain records exist. Is there no trust left in the world?

The whole area of fringe benefits concerns our industry. As I understand it, the special tax treatment currently accorded group term life insurance and similar cafeteria plans could be or would be repealed.

Also the exclusion for health insurance benefits paid by employers would have a cap of $70 a month for a single individual and $175 a month for a family. This could have a terrible impact on our sales efforts, and I just fail to understand the long-term benefit to the Government for it.

Is it not better to encourage employers to provide benefits such as these through tax incentive rather than creating the need for some form of socialized insurance, and that is where it would end up.

A scourge of many agents is the formidable task of making a guess a year in advance of how business will turn out and then estimating taxes. It becomes very difficult. The new law did not help this at all but made it worse. Small independent agents are going to have to depend more and more on tax advisers with the resulting cost to them.

Individual retirement accounts, IRA's, have become an extremely useful retirement plan for small agencies. The tightening down of some of the IRA rules seems unnecessary. Many other of the individual changes are or could be damaging to independent agents such as taxing interest free loans, bonuses accrued, telephone excise tax continued and the whole area of capital gains is a concern.

Apparently the proposers of some of these changes have not been shopping for new cars recently for it seems foolish to call a luxury car one valued at $16,000. Many mid-sized cars today have price tags very close to that. For an agency in rural America who puts a lot of miles on a car, it is going to be a real burden and costly having to write those cars off over longer periods of time.

I would like to close with a general statement quoting a recent article in the "Independent Agent," an insurance trade association magazine.

"A growing number of independent agents are becoming angered at the progression of major tax law changes that have been signed into law in recent years. Three significant tax bills have passed Congress in only 4 years. Many taxpayers are finding effective tax planning all but impossible."

This item was discussed earlier and it is a problem. "Already there is talk of another tax bill this year. The famous old Farmer's Almanac hit the nail on the head when it wrote 'If Patrick Henry thought that taxation without representation was bad, he should see how bad it is with representation.' " [Laughter.]

[Applause.]

[The prepared statement of Mr. Lane follows:]

Statement by:

Thomas E. Lane, President
Kluthe & Lane Insurance - First American Systems, Inc.
Before Subcommittee on Tax Reform Proposals
Senate Small Business Committee
February 14, 1985

I am Tom Lane, President and CEO of an insurance agency organization headquartered in Rapid City, South Dakota with additional offices in Sturgis and Mitchell, South Dakota, Denver, Colorado, and Buffalo, Wyoming. We are independent insurance agents functioning as sales and service offices for a number of different insurance companies. We sell and service all forms of insurance such as Commercial Property and Casualty coverages, Personal Auto and Homeowners coverages, Life, Disability, and Health Insurance for both individuals and groups.

I am of the opinion that the 1984 Tax Reform Act is a lot more taxing than reforming. Although there are many good features to the proposals being presented, I see several areas that will have a particular impact on my industry.

It appears that Universal Life Insurance will continue to receive its favorable tax impact, and this is terribly important for it has become a popular product. Under the old law, Group Term Life Insurance in excess of $50,000 provided for retired employees did not result in taxable income to those former workers, but now under the new proposals any cost of excess coverage over $50,000 is taxable income less any contribution made by the retired employee. Key employees could be damaged when they are provided insurance under a plan that is considered discriminatory. Under such plans, the actual full cost of the insurance paid by the employer is included in the employee's income. These items concern me.

As a small business person, I am concerned with some of the Expensing provisions. As an example, if we were to buy a new desk or computer or typewriter, we could normally recover that cost over several years, or could elect to take a current write-off on as much as $5,000 of the cost. That amount increased in 1984 to $7,500, but now that additional $2,500 has suddenly disappeared - and freezes it there until 1988. This could have quite an impact on real small offices.

The loss of the investment tax credit for property used less than 50% of the time in business could have a significant impact on small insurance agencies. Autos, computers, trucks, entertainment, recreation property, could all be involved.

The record keeping necessary with the new proposed laws, also has a terrible impact on small one- or two-man businesses. The new law tightens the record keeping requirements so much that many small agents will probably get in trouble with the IRS over it. I am particularly upset that the owners sign a written confirmation that certain records exist - is there no trust left in the world?

The whole area of fringe benefits concerns our industry. As I understand it, the special tax treatment currently accorded Group Term Life Insurance and Cafeteria plans would be repealed. Also, the exclusion for Health Insurance benefits paid by employers would have a cap of $70 per month for a single individual and $175 per month for a family. This could have a terrible impact on the sales efforts of insurance agents, and I fail to understand the long-term benefit to the government. Is it not better to encourage employers to provide such benefits through tax incentive rather than creating the need for some form of socialized medicine?

A scourge of many agents is the formidable task of making a guess a year in advance of how business will turn out, and estimating taxes becomes very difficult. The new law did not help this at all, but made it worse. Small independent agents are going to have to depend more and more on tax advisors, with the resulting cost.

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I would like to close with a general statement quoting a recent article in The Independent Agent, an insurance trade association magazine. "A growing number of independent agents are becoming angered at the progression of major tax-law changes that have been signed into law in recent years. Three significant tax bills have passed Congress in only four years. Many taxpayers are finding effective tax planning all but impossible.

Already there is talk of another tax bill this year. The famous Old Farmer's Almanac hit the nail on the head when it wrote, 'If Patrick Henry thought that taxation without representation was bad, he should see how bad it is with representation.'"

Thank you very much.

Senator **Pressler**. That is great. I am going to have to remember that line and use it once in a while.

Let me cover some of the issues. I know that some of these issues probably sound detailed to the man on the street, but they are the things that we are wrestling with and they do become very, very important.

Kay, I really enjoyed your statement, and I know that you talked about the accelerated cost recovery. Has this been helpful in your business?

Ms. **Riordan-Steuerwald**. Very definitely. And I say when it is helpful for someone that has been in business as many years as I, think what it means to the young person or the person going into small business to begin with in order to charge off their equipment and their vehicles in an accelerated time period. And of course I think it is very good for businesses like Milo's because you sell more automobiles. I just think in general that it is great for small business. I would hate to see it repealed.

Senator **Pressler**. Now in your testimony it was very unique and very conscientious of you to have your accountants figure out what the tax impact would be approximately under each of these plans, and generally speaking you found that you had some savings.

But in some other businesses the loss of credit and deductions called for by major reform proposals sometimes is offset to some degree by reductions in the individual corporate tax rates. You did find in your particular business that there would be a lower total tax?

Ms. **Riordan-Steuerwald**. It would be a lower total tax. But again I qualified the fact that—and I should after 30 years—not be working on borrowed money. It is the person in business today that has to borrow money that has a hard time surviving. I think that is what makes the difference, and that is why I feel some of these new proposals are very dangerous. It is a lot different for an old established firm like I am and has been around for as many years as I have and somebody that in the last 5 to 10 years trying to get a business started.

Senator **Pressler**. Of course we in the Senate have the unpleasant duty of dealing with both the revenue side and the spending side. They said that back in the 1960's it was fun to be a Senator because we were passing all these programs that we are now going to have to pay for or reduce and yet raise revenue. Each of these alternatives will have to raise at least as much revenue, although we hope that if there are changes it will be on a fairer basis.

Milo, I was going to ask you if the accounting of inventories is something that in the car business needs to be changed, or is that being done about right?

Mr. **Rypkema**. I think basically because there are many different ways in that. Most of the people are using LIFO in their businesses, and I think that that needn't really be changed.

Kay talked about the change that was instrumental in my selling more cars. You know, that is basically true, but one out of the seven Americans are tied to the industry, and we all know in this Nation where our economy was when the auto industry was at a low ebb.

Some of these things filter out and the individual pays more taxes basically than most small corporations. I brought with me a stub of my son's last pay check where he paid a 33-percent flat tax on his payday. Now, you know, the 15 to 18 percent of the small corporation, but that is where the upheaval is going to come in this country. Like my final statement, it is deficit spending that is causing the tax to be raised, and unless you get that in line you are going to see things happen in this country that have happened in other nations.

Senator **Pressler**. I certainly concur, and I have kept my voting during my time in the Senate within a balanced budget. I voted for the across-the-board freeze last year and will again this year. I think that our No. 1 domestic problem is the hugh deficit.

I also agree with what you said about a need for a comprehensive farm policy. I attended the farm rally in Pierre on Tuesday, but I think that is particularly true in the trade area where we do our agricultural trade separate from our general agreement on trade tariffs. So I very much appreciate your comments in that area.

Mr. **Rypkema**. At one time in the South Dakota Automobile Dealers Association we had 1,000 members. We are down to 180, and it is our prediction that in the next 5 years we will be down to probably 110. Now as we are losing those dealers, we are losing them in the small farm rural communities and it hurts everybody. It has complicated their problems. The farmer that lives out there doesn't have an agency, but that is where it is affecting the small business person and our farm policy is killing our small communities.

Senator **Pressler**. Tom Lane, I very much appreciate your testimony because it gives us a chance to ask about this issue of taxation of fringe benefits, something that, in general, Senator Dole has supported but Senator Packwood has opposed, I believe.

The difficulty falls in that if the fringes were not provided, that it probably would ultimately become a public expense in some cases.

Mr. **Lane**. That is my opinion, yes, and that is my biggest concern.

Aside from the fact that we have just become used to them, people in America today expect—as part of employment, health insurance—some disability insurance and a lot of varied things. There is all kinds of stuff. And as we start to tax those fringes or take them away, they are still going to demand them in some way. We have seen that in the unions. The unions demand it. If business doesn't pay for it, Government will pay for it. I think the public will have that same demand, and that is our concern.

Senator **Pressler**. Also this was the first testimony we have had on the expensing provision which goes back to $5,000, as I understand it, or at least there has been a change there.

Mr. **Lane**. I think particularly in your very small businesses, and that is a real item in the really tiny, one-man, as I said, one- or two-man business where we aren't so concerned about long-term. Our businesses are very small capital intensive and the only thing we have to buy is a new typewriter or a new desk or something. We don't care to write that off over a long period of time. We would like to expense it and get it done, and that is not going to be possible as I understand it. That is a problem.

Senator **Pressler**. Do my colleagues have a question or two?

Mr. **Hudson**. I would, first of all, like to say thanks to Tom for getting back tc direct expensing. I have two questions.

All of you to some extent are involved in attracting investment of some kind to your businesses. We heard in Memphis from a restaurant owner trying to attract investment that it was his feeling that most of the potential investors were more concerned about tax provisions as a reason to invest rather than whether or not his restaurant was going to make any money.

My question is: Is your sense or perception when you are out there trying to attract investments, that most of these potential investors are looking at your bottom line or are they looking at the Tax Code?

Mr. **Rypkema**. I think a combination of both, but I think we need to recognize the fact of the risk factor that is taken by the individuals in this type of thing. You know, in my place of business my wife's pillow cases are mortgaged, but the individual if he doesn't like to work there in the evening he can go home with his tool box and he isn't out. But that is the risk factor that we take in the business of making that investment and that is what America has been built about.

Mr. **Hudson**. Do you find that the investors are more concerned than they used to be about tax provisions?

Mr. **Rypkema**. Oh, I think so because they are not going to make that investment if they don't know where the tax provisions are for the long haul. They can't do it on a year-to-year basis. That is the crux of our farm policy and they have to know that it isn't upset every year.

Mr. **Hudson**. The next question affects your own decisionmaking as business owners and business participants. Do you, perhaps more than you used to, when you think about making a business decision, look for to what is in the tax law as opposed to what you think would be an economically producing decision for you?

Ms. **Riordan-Steuerwald**. Speaking for myself, I never look at the tax law.

Mr. **Rypkema**. I think you have to look at it if you want to stay alive.

Mr. **Lane**. I would say we do. I hire two CPA's in staff and we spend an awful lot of time on tax law and we have to. It is the only way we can survive sometimes.

Mr. **Walsh**. I have one question concerning charitable deductions because I think the arguments surrounding that are much the same as the fringe benefits. People have argued that the tax considerations for making charitable contributions are not controlling and people make them anyway and therefore the charities won't suffer. Others have argued that the tax considerations are quite strong and charities will suffer and eventually the Government will have to take over what those charities have been doing.

I just wonder if any of you want to comment on that?

Mr. **Lane**. I would like to. We are just winding up a YMCA capital funding drive and I was chairman of it here. And I think that is terribly important. Without some tax consideration corporations are just not going to give, and we found that in many cases. I can speak of one specific individual who is perceived in the community as having lots of money. That individual was very, very small in giving to the YMCA, and the statement was made, I am not going to give more than I can benefit from in tax credits some place. And so it does become a real issue for charitable organizations.

Mr. **Rypkema**. I think it needs to be maintained. We see our hospital in this community that is recognized as one of the finest. Many of the tax deductions that were given to create that from the citizenry level, I think you would stymie all types of that. Maybe those charitable organizations have a better record of doing what is right than our Government does.

Ms. **Riordan-Steuerwald**. I think you two have answered it and I concur.

Senator **Pressler**. Yes; there is a dilemma on charitable contributions. Again, playing the devil's advocate to some extent. This doesn't happen in South Dakota very much, but some of these big charity balls in Washington, DC or New York or wherever, it has been found that actually they don't yield that much to charity. They might raise $35,000, but there is $25,000 worth of expenses.

Also, some of the big charity concerts put on by some of the great rock stars have actually been found not to contribute anything to charity because of the expenses of getting the people there and flying them in from London or wherever. There is kind of a move to require that at least 60 percent of the money raised actually gets to charity and that is something that we need to work on.

Mr. **Lane**. Let me give you another example in the small town—rural America. We found a situation this past year involving one of these telephone solicitation schemes. We got to the bottom of it and found that 10 percent of that money raised stayed here and 90 percent went out of town.

I think someone earlier on one of the earlier panels said let's get to the key issue. Let's not kick out all charitable organizations or giving, but let's try to find those problems and address them. The 60 percent you mentioned, I think it could be higher frankly. I think it could be 80 percent. It is terrible when that much of the money goes toward the effort of raising it. I concur.

Senator **Pressler**. Yes.

Mr. **Rypkema**. Senator, you know that in South Dakota we like you or you wouldn't be our Senator. But one of the things I think the public out there has a feeling about, and it is like the recordkeeping on the automobile, it seems that our Senators lose control of things and they turn it over to a committee that draws up some ungodly horses. You know, you really get the blunt of that type of criticism being our Senator and there ought to be a way of curtailing that before it happens.

Senator **Pressler**. Well, you have said it better than I could. One of the most frustrating things is that our Federal Government is so big and the bureaucracy has gotten so powerful that when they get laws in the various agencies and issue the regulations to implement them, it sometimes comes out differently than Congress intended.

Those of us in the House and Senate have usually only been around Washington a few years, but we are wrestling with the fellows who have been in the civil service for 20 or 30 years and many of them are very good people. I am not saying that they are not, and I never make it my practice to pick on them. On the other hand, some of them would like to be legislators, but they don't want to run for any office.

We find that in the Federal Trade Commission and they are making rules. As a matter of fact, I tried to hold up the funding for some other activities because they were engaging in legislating, in my view.

So we need very good civil servants who carry out the wishes of Congress and the administration and sometimes we don't get that. But I clearly think that it is an example, this mileage records. They say it will get $100 million more, but it is going to cost several billions of dollars for small businesses and individuals to do it, which will mean reduced revenue because of loss of productive time.

That is where hearings such as this come in handy. In fact, yesterday the Iroquois High School came to listen to part of the hearing and some of them felt it was a very complicated sounding hearing. But I explained to them that Senators don't just vote on foreign policy every day and we don't listen to the President speak every day. A lot of our days are spent in committees ironing out the details of these difficult issues and trying to be fair, and I think we can do a lot better. Of course, anything worth doing is not easy.

But you have said it very well, that sometimes our best efforts get diluted over in the bureaucracy, and it is our job to be sure that that doesn't happen.

I want to thank this panel very much, and to say that I will be meeting with any groups who want to meet with me after this meeting. But to those who do not wish to meet with me and just want to say hello, I am going to first stand by the doorway just to say hello to people as they go out, and then I will meet with any groups who wish to meet with me on any subject.

Thank you very much.

[Whereupon, at 11:01 a.m., the committee adjourned, to reconvene at the call of the Chair.]

[Additional material follows:]

**ELLSWORTH
AIR FORCE BASE
FEDERAL CREDIT UNION**
PO Box 277 -- Building 4005
Ellsworth Air Force Base, SD 57706

February 13, 1985

The Honorable Larry Pressler
407-A Russell Senate Office Bldg.
United States Senate
Washington, D.C. 20510

Dear Senator Pressler:

I would like to apologize for being unable to attend the Senate Small Business Committee Meeting that will be held in Rapid City on February 14, at 9:00 a.m. at the Alex Johnson Hotel. Unfortunately, other previous commitments will prevent me from attending. I would like to give you our input as a small business regarding the currently proposed tax reform proposals on small businesses. I would also like our comments included in the official hearing record.

First of all, a little bit about our institution. We are a federally chartered Credit Union with assets in excess of $10,000,000 and we represent ten thousand members.

We feel the impact of taxation on federally chartered Credit Unions would have a very adverse effect on our net earnings. As you know Credit Unions are non-profit making institutions that return all of their available net earnings back to their members after meeting reserve requirements. The complexities of running a financial institution today are far more intricate than they were years ago. Therefore, the earnings needed to offer the services our members have come to appreciate and demand have become greater and greater. The proposed taxation issue would adversely affect that net earnings power because it would create another expenditure that was not previously there.

The forefathers of our Government foresaw the need to give Credit Unions a tax exempt status, due to the uniqueness of their nature. One major uniqueness is the limitation in their field of memberships. Credit Unions, unlike Banks and/or Savings and Loans institutions, cannot open up accounts for any individuals that are within their field of membership. For example, many times people will walk into our Credit Union and ask for Credit Union membership and we have to turn them away because they are not connected with the Air Force or family members of Air Force personnel. It is this limitation in our field of membership that makes it harder for us to expand and attract more dollars needed for the overall operation of the Credit Union. Any additional burden on our bottom line of operations will adversely affect our ability to continue to service our members and remain a viable strong financial institution.

1985 FEB 20 AM 11: 16

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OFFICE PHONE 605-923-1405 | LOAN DEPARTMENT 605-923-1446

We understand the need for tax reform and support the President's issues on reduction of the Federal deficit. We so strongly believe in his efforts that we supported the funding of the National Credit Union Administration share insurance fund. This funding represented one percent of our assets which was $100,000 that was deposited into a potentially non-interest bearing account. This account which totals several billions of dollars is now being utilized by the government. This funding helps government meet their cash flow needs and minimizes to a great extent their operating expenses.

Thank you for taking the time to read my comments on this taxation issue. If I can be of any further assistance regarding this taxation issue, please do not hesitate to call upon me.

Sincerely,

Kitty Doeden

Kitty Doeden
President

KLD/cab

cc: Bill Donovan

Oglala Lakota College

P.O. Box 490
KYLE, SOUTH DAKOTA 57752
Telephone (605) 455-2321

COLLEGE PRESIDENT
ELGIN BADWOUND

BOARD CHAIRMAN
JOHN STEELE

FEB 1 [illegible]

TESTIMONY

of

BIRGIL L. KILLS STRAIGHT
Consultant to the Oglala Lakota College
and
Project Coordinator of the Tatanka Iyacin Project

PRESENTED TO
SENATOR LARRY PRESSLER

HEARING
Rapid City on February 14, 1985
"TAXES and the ECONOMY"

The Oglala Lakota College and the American Association of Community and Junior Colleges (AACJC) are sponsoring a project on the Pine Ridge Indian Reservation 'to create awareness to Indian businessmen and Indian youth the opportunities existing in the private business sector' with funds the Minority Business Development Agency (MBDA) within the Department of Commerce. The six-month project is entitled TATANKA IYACIN and it is in the amount of $10,000. Tatanka Iyacin (TA TONKA EE YAH CHIN) translates "In manner of the buffalo" in the language of the Lakota people and it is given this name because of what the project can do: to provide information, to provide technical assistance, to give strength as an ally, and to enhance Lakota businessmen and Lakota youth to be self reliant and provide for themselves with self sufficiency projects in the private sector.

The tatanka (bison) provided spiritual and material goods to our forefathers. We used every part of the buffalo - for food, dwelling, clothing, robes, parfleche equipment, tools, meats, even the waste provides for the fires for the tipis. Thus, the comparison of the tatanka to the college project.

With Shannon County boasting unemployment rate of up to 87-percent and with the lowest per capita income in the United States, we must begin developing opportunities for businesses to flourish from the individual and family up to the tribal level. The communities (tiospayes) must take control of their own destinies in the economy. Education has the dominant role in providing the much needed information, technical assistance, and all phases of developmental work. The Oglala Lakota College is committed to this mission.

It is only recently that I learned that the federal government is contemplating on the reduction of funds and/or the complete elimination of the Small Business Administration (SBA). Senator Pressler, this is a giant step backwards for the economy not only for the excited young entrepreneurs in the school systems on the reservation but for the state of South Dakota as well! From what I hear, President Reagan will then propose the creation of the BIG BUSINESS ADMINISTRATION to assist large multi-national corporations!

The staff of Tatanka Iyacin have just begun to excite future Lakota businessmen in considering taking the initiative to start and build businesses from within (the reservation) and not have to rely on outside help. You should be commended for bringing these hearings to the people in South Dakota so that they may give you their views on taxation and the economy in general. I invite you to come to the Oglala Lakota College, as well, and discuss our issues on the reservation as it pertains to economic development. We are having a conference in late April 1985 and wish to invite you to participate as a guest speaker. I will send you more information as it comes off the press.

For the record, I am enclosing some information on the unemployment, US NEWS release, and Annual Report of the college, as well as some other information.

Thank you for this opportunity to express our concerns.

America's Richest, Poorest Counties

A variety of communities—some peopled by bureaucrats, some by Eskimos—make up the Census Bureau's new list of counties with the highest and lowest per capita incomes.

The 15 Richest

Bristol Bay census area, Alaska. Per capita income in the 1980 census: $14,948. A fishing center.

Falls Church, Va. $12,685. A suburb of Washington, D.C.

Alpine County, Calif. $12,861. Ski resort in the Sierra Nevada.

Juneau census area, Alaska. $12,757. Capital of the state with the highest per capita income.

Arlington County, Va. $12,565. A suburb of Washington, D.C.

Marin County, Calif. $12,525. A suburb on San Francisco Bay.

Montgomery County, Md. $12,339. A suburb of Washington, D.C.

Alexandria, Va. $12,209. A suburb of Washington, D.C.

Pitkin County, Colo. $12,054. A ski-resort area around Aspen.

Valdez-Cordova census area, Alaska. $11,642. On Alaskan pipeline.

Fairfax County, Va. $11,551. A suburb of Washington, D.C.

Anchorage census area, Alaska. $11,368. Alaska's largest city.

North Slope census area, Alaska. $11,006. Northern end of pipeline.

New York County, N.Y. $10,889. Manhattan borough of New York City.

Johnson County, Kans. $10,885. A suburb of Kansas City.

The 10 Poorest

Shannon County, S.D. $2,637. A Sioux Indian reservation covers the entire county.

Buffalo County, S.D. $2,642. Mostly a Sioux reservation.

Starr County, Tex. $2,668. On Rio Grande; 97 percent Hispanic.

Owsley County, Ky. $2,948. Appalachian area in eastern Kentucky.

Ziebach County, S.D. $3,042. Partly an Indian reservation.

Hancock County, Tenn. $3,054. Appalachian farming area on the Kentucky border.

Maverick County, Tex. $3,100. On the Rio Grande; 90 percent Hispanic.

Todd County, S.D. $3,130. A Sioux Indian reservation.

Zavala County, Tex. $3,202. Near the Rio Grande; 89 percent Hispanic.

Wade Hampton census area, Alaska. $3,203. Along the Bering Sea, with a population 93 percent Eskimo. ☐

GOP message: Inflation is slowing.

Democrat ad: Elephant in a china shop.

"Now a Word From Your Local Candidate"

As the November 2 elections draw closer, television screens are filled with commercials designed to sell not soap or beer but political candidates.

An elephant, symbol of the GOP, rampages through a china shop while an announcer intones: "The Republicans have made a mess of things."

A woman unpacks a bag of groceries in her kitchen and says: "Prices are still too high, but they are not going up every week the way they did before we elected President Reagan."

In Massachusetts, friends and relatives of Senator Edward Kennedy offer examples of his kindness and caring in a series of messages trying to deal with the "character" issue that has dogged him for years.

In California, as a mushroom cloud grows on the screen, a small boy says: "I want to go on living." Then an announcer warns: "Pete Wilson opposes the nuclear-arms freeze. Jerry Brown supports it. Vote for your life. Elect Jerry Brown to the U.S. Senate."

In all, more than 100 million dollars is being spent this year on political television ads. The commercials are consuming up to 70 percent of campaign funds for many candidates. Lewis Lehrman, Republican candidate for governor in New York, is doling out an estimated 8 million dollars in a drive to make his name known to voters.

Analysts consider this year's crop of TV ads more substantive than usual. Explained David Sawyer, who produces spots for Democrats: "People are concerned about very specific issues." ☐

Has Reagan Really Cut Bureaucracy?

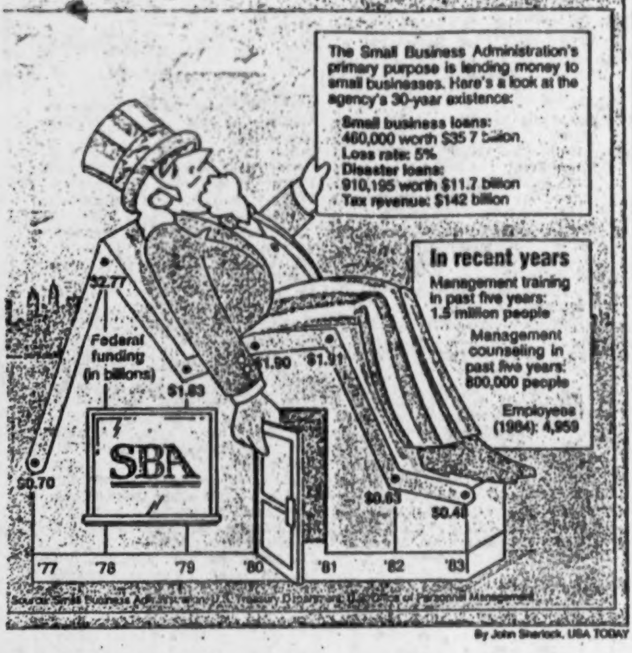
Despite heavy cuts in many agencies, Ronald Reagan is falling behind on his goal of reducing the size of the federal work force.

Not counting postal workers, over whom the President has no control, latest government statistics show 2,192,972 civilians on the executive-branch payroll in June. That's 5,316 more than the total on Inauguration Day in 1981.

Reagan's aim, outlined in budget proposals, is to shrink the number of federal jobs by 75,000 by 1984.

Total employment in the government's 22 biggest agencies—

	Jan., '81	June, '82	Change
Defense Department	972,990	1,045,360	+7.4%
Postal Service	655,748	667,782	+1.8%
Veterans Administration	235,460	240,575	+2.2%
Health and Human Services Department	159,945	150,090	−6.2%
Agriculture Department	122,889	127,293	+3.6%
Treasury Department	131,837	121,919	−7.4%
Interior Department	79,546	84,799	+6.6%
Transportation Department	71,641	62,376	−12.9%
Justice Department	56,807	55,949	−1.6%
Tennessee Valley Authority	51,841	39,913	−23.0%
Commerce Department	47,010	35,248	−25.0%
General Services Administration	37,240	31,060	−16.6%
State Department	23,521	24,387	+3.7%
National Aeronautics and Space Administration	23,696	23,497	−0.8%
Labor Department	23,544	18,956	−19.5%
Energy Department	21,692	18,537	−14.5%
Housing and Urban Development Department	16,726	14,588	−12.9%
Environmental Protection Agency	14,927	12,623	−15.4%
Panama Canal Commission	8,774	9,158	+4.4%
International Communications Agency	8,084	7,926	−2.0%
Office of Personnel Management	8,530	6,651	−22.0%
Education Department	7,538	5,689	−24.5%



The Small Business Administration's primary purpose is lending money to small businesses. Here's a look at the agency's 30-year existance:

Small business loans: 460,000 worth $35.7 billion.
Loss rate: 5%
Disaster loans: 910,195 worth $11.7 billion
Tax revenue: $142 billion

In recent years

Management training in past five years: 1.5 million people

Management counseling in past five years: 800,000 people

Employees (1984): 4,959

Source: Small Business Administration, U.S. Treasury Department, U.S. Office of Personnel Management

By John Sherlock, USA TODAY

COVER STORY

Reagan eyes business agency cutoff

Critics cite default rate, minority program

By Haya El Nasser
and Constance Mitchell
USA TODAY

If you had asked Mary Alicia Roach Paige three years ago what she thought of the Small Business Administration, she would have told you the agency is "in the business of putting business out of business."

Paige, her software services company $100,000 in debt, was turned down twice for an SBA loan because she lacked collateral. On the third try, after help from her congressman, the SBA loaned her $100,000, and her opinion changed. "I don't think I could have stayed in business without them," says Paige, whose Computer Engineering Associates Inc. of Avon, Mass., had sales of $2 million this year.

Paige is one of 460,000 entrepreneurs in the past 31 years who have used loan money from the SBA to start a business or stay in business. Now that President Reagan has asked Congress to eliminate the agency as a federal debt-reducing move, observers are re-evaluating the need for the SBA.

"There are so many viable businesses out there hiring people and doing great things for the economy," says Lewis Shattuck, executive vice president of the Smaller Business Association of New England, the nation's oldest small-business organization. "Many of those businesses would not be around if it were not for the SBA."

Since it was founded in 1953, the SBA has:

- Made or guaranteed more than $35.7 billion in loans, primarily to would-be entrepreneurs and small-business owners like Paige.
- Organized seminars, with such titles as "Women's Business Ownership," "Pre-Business Workshop" and "Selling to Government," which travel to more than 100 cities a year.

Please see COVER STORY next page ▶

COVER STORY

Some call SBA a waste

Continued from 1B

and attract more than 300,000 participants.

- Provided 910,195 disaster-relief loans totaling $11.7 billion to victims of floods, hurricanes, tornadoes and earthquakes. One of the recipients was toolmaker Ingersoll-Rand Co. (ranked 156 on the 1983 Fortune 500 list), which received $20 million to help rebuild a factory leveled by Hurricane Agnes in 1972.
- Helped thousands of small firms win government procurement contracts.
- Created 33.4 million hours of work, $468 billion of the gross national product and $142 billion of income-tax revenue for the U.S. Treasury as a result of business activity fueled with SBA business loans.

When the SBA was created, there were more than 4 million small businesses in the United States. Today, there are more than 13 million.

Despite the accomplishments, critics view the SBA as an agency that wastes taxpayers' money by propping up people ill-suited for business in companies that don't work.

Darrell Hopper launched Midesha Enterprises Inc., an office-supply company in Southaven, Miss., with a $25,000 SBA loan 10 years ago. Another $25,000 SBA loan helped him expand, and yet another $145,000 SBA loan put his company in a new building. Midesha Enterprises sales will approach $1.25 million this year.

Yet Hopper says the high default rate on SBA loans — 25% on direct loans — may be enough to justify eliminating the agency.

"From a selfish standpoint, I hate to see it happen," he says. "On the other hand, if a large percentage of people dealing with the SBA are not successful and the SBA is losing a great deal of money, then we have to look at the overall picture of the economy."

In a survey conducted last summe[illegible] the National Federation of Indepen[illegible]t Business, most small-business ow[illegible]rs said they thought the SBA had no effect — good or bad — on their operations.

Three-fourths said they would turn to private consultants or retired business owners for management advice before they would turn to an SBA staffer for counseling. Two-thirds of the respondents said they have never written or called SBA for information or assistance. Nevertheless, most of these business owners said they would not be in favor of eliminating the SBA, said federation spokesman Mike McKevitt.

"It will not break our heart if they eliminate the small-business development centers," McKevitt says. "But they should keep their advocacy role. Small business is the major portion of the economy, and we should have our own identity and our own voice. That should not change."

The SBA also comes under fire for its handling of special programs that aid women and minorities.

One of the most criticized is known as the 8(a) certification program, which lets minority businesses sell goods and services to the government without competitive bidding.

During fiscal 1983, the SBA generated a record $2.3 billion worth of government contracts for the 2,300 minority-owned businesses that are members of the program. Those contracts amounted to only 1.3% of the money the government spends to buy goods and services from businesses, but larger businesses view the program as a handout.

Joshua Smith, president and founder of Maxima Corp., a company recently labeled one of the USA's fastest-growing small businesses by *Inc.* magazine, says the criticisms of the 8(a) program are unfair. "They are looking at 8(a) as a welfare program, but it is not. It is a good program that has given minorities the chance to demonstrate their abilities, which has helped many of them participate in the business mainstream."

Jeanne Paluzzi, an officer of the Chicago-based National Association of Women Business Owners and president of JGP Marketing Group International Inc., a public relations firm in Livonia, Mich., is an even more ardent supporter.

"The SBA has had a reputation of being a last resort for businesses who shouldn't go into business in the first place," Paluzzi says. "That reputation is not justified, because the direct loan program is not the only SBA lending program. We have to fight to change that perception in the financial community."

The SBA's benefits extend beyond its lending and government-assistance role, says Jerry Gulan, executive vice president of the 40,000-member National Small Business Association in Washington, D.C.

"Small businesses feel [illegible]t for the first time, there is a spokesperson at the top level in Washington that is working on their behalf," he says, calling the SBA's advocacy push "its best achievement in recent years."

Gulan questions whether other federal agenc[illegible] can take over the job of promoting sm[illegible] businesses. "I don't see how any other [illegible]ency can carry the functions of the S[illegible]" he says. With 600,000 small businesses formed last year, "It is important to have this kind of agency give guidelines and help small businesses."

Paluzzi, of the women business-owners group, also fears that small business once again will take a back seat to big business. "We're concerned that the advocacy in the administration, that the management and technical assistance, is going to disappear."

M-O FEDERAL CREDIT UNION
New Federal Building
Huron, South Dakota 57350

Phone: 605-352-9040
Manager: Darlene Cameron

February 19, 1985

Honorable Larry Pressler
407-A Russell Senate Office Bldg.
United States Senate
Washington, D.C. 20510

Dear Senator Pressler:

We would like to take this opportunity to express our views concerning the current tax reform proposals regarding small business. This legislation, if enacted into law, would repeal the long-standing tax exemption presently extended to Federal Credit Unions.

We feel that the current tax exemption for Federal Credit Unions should be preserved, and that you are in an excellent position to have a very strong impact on how Congress finally resolves this issue. Since every credit union in South Dakota is federally chartered, each credit union in South Dakota would be adversely affected by such a change in the law. NAFCU has delivered the Federal Credit Union views on this matter to Congress on numerous occasions in the past, and we will continue to do so. Now is the time for you to join in that effort. We feel that tax exemption should be continued as credit unions remain non-profit organizations set up for small borrowers and small savers.

Due to our size, we feel that taxation would create a financial burden. We would like our comments included in the official hearing record. We have 1,093 members; the asset size of our credit union is $2,036,000; and the amount we sent to NCUA as our share insurance deposit was $17,586. May we remind you that our NCUSIF deposit reduces the federal deficit dollar for dollar.

If additional information is needed, please do not hesitate to contact us.

Sincerely,

Paul Nettinga

Paul Nettinga
Vice-President
M-O Federal Credit Union

1985 FEB 22 AM 9 24

33 +9

CREDIT
UNION

Mc COOK COUNTY FEDERAL CREDIT UNION
P.O. Box 501 • Salem, South Dakota
Office Hours: Mon., Thurs., Fri. 12:00 - 5:00 p.m.
Phone - (605) 425-2143

Member of
South Dakota Credit
Union League

Member of
Credit Union National
Association, Inc.

February 11, 1985

The Honorable Larry Pressler
407-A Russell Senate Office Bldg
U.S. Senate
Washington, D.C. 20510

Dear Senator Pressler,

I understand several of the tax reform plans to be considered by Congress this year would repeal the tax ~~any~~ exemptions presently extended to Federal Credit Unions.

I am strongly opposed to this. As of January 31, 1985 we have 380 members in our credit Union; with assets of $386,182.00

We sent NCUA a share insurance deposit of $3,043.62 So actually our NCUSIF deposit reduces the federal deficit by $3,043.62.

We can't afford to be taxed further
Hope you agree with us.

Respectfully yours
Elva V Lundgren - Mgr/treas.

+G
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1985 FEB 15 AM 11:02

Services Center
FEDERAL CREDIT UNION · P.O. Box 704, 609 W. 21st, Yankton, SD 57078
Phone (605)665-4309

February 13, 1985

The Honorable Senator Larry Pressler
407-A Russell Senate Office Bldg.
United States Senate
Washington, D.C. 20510

Dear Senator Pressler

I was unable to attend the hearings which you conducted on behalf of the Senate Small Business Committee. I understand that you were conducting the hearings to guage the impact of tax reform proposals that have recently been circulating.

One such proposal is to tax credit unions. I am keenly aware of the fact that someone must be taxed if new revenues are to be found and that no one business wants to be taxed. However, federally insured credit unions recently in a move that improved their own insurance fund and reduced the federal deficit by almost 1 BILLION DOLLARS.

Taxation of credit unions will surely mean that "PEOPLE PAY TAXES-BUSINESSES DON'T". Any amount of tax that this credit union will pay will most definitely come from the pockets of our 3,000 members.

Personally I support the dual movement of the Administration to reduce the deficit through reduced spending (including the military) and tax simplification.

Again, I am sorry that I was unable to attend your hearings, but I hope that my comments have been constructive and will be useful in the ultimate resolution of this problem.

Sincerely

David J. Wright
David J. WRight
Manager

DJW

Sisseton Co-op Federal Credit Union

15 West Maple St. -:- Sisseton, South Dakota -:- Phone 698-7481

The Honorable Larry Pressler
407-A Russell Senate Office Building
United States Senate
Washington, D.C. 20510

Dear Sir,

I am writing in regards to the Bradley-Gephardt FAIR tax plan which would impose a federal tax on Federal Credit Unions. I represent 630 members who pay taxes every year and if this plan gets passed they would in a way be taxed again. The Credit Union would'nt be able to pay them a good dividend on their hard earned savings because our operating expense would go up. Our Credit Union has assets of 801,000.00 dollars and 1% of that has been sent to NCUA for our share insurance fund. This fund in turn [illegible] has reduced the federal deficit dollar for dollar. We feel we have done our part in reducing the deficit and they should look elsewhere for solutions to reduce the deficit.

Please include my comments in the official hearing record in the hearings you are conducting on Feb. 13 and 14 concerning this matter. Thank You.

Sincerily,
Brian W. Hanson Manager

Brian W. Hanson

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1985 FEB 19 AM 10 32

Tax and Agricultural Meeting
Alex Johnson Hotel - February 14, 1985

Honorable Senator Larry Pressler:

My name is Bill Stone. I own and operate a small ranch 100 miles north east of Rapid City on the Cheyenne river. I am a Republican.

Concerning the subject of tax simplification and reform let me offer these thoughts.

Thoughtful people believe that tax reform and tax increase will ultimately become one. I believe this assumption is correct - not only correct but unavoidable.

The belief by supply side economists that economic growth will balance the national budget was questionable at the onset and time has proven it was only wishful thinking.

That forces us all to look with candor at our financial plight. Is a national debt approaching $2 trillion and yearly deficits nearly $200 billion, plus a national budget pushing $1 trillion a reasonable expectation of the American economy?

From my vantage point as a rancher/farmer the answer is NO if it means continuing to pay highly inflated interest that drives up the dollar value until my products, and other American products, cannot compete in world trade. Parenthetically, I am tired of high interest subsidizing over $700 billion in unwise foreign debt by the banking Community, while failing American entrepreneurs are labeled "poor managers". I am tired of my government creating financial policy which makes competition nearly impossible and then being branded as an irresponsible "consenting adult".

To compete against standards of living much below ours is tough enough without having to compete WITH our own government's policies.

It appears to me that the yearly deficits must be erased and the debt itself attacked. This will require sacrifice at home and immediate changes in our interaction with other nations. We cannot change others significantly except as we are willing to change ourselves.

That forces us, as a nation, to decide if (1) we are willing to reduce our standard of living to help save the nation and, (2) if the paranoia of our leadership and the greed of the military/industrial complex is willing to grasp sanity long enough to aid in that salvation.

In order to support tax reform taxpayers must be assured that genuine business expenses will be deductible. However, loopholes which distort normal supply and demand business operations or shelter the income of those most able to pay taxes (those who gain the most from living in America) must be eliminated. Shelters that permit and encourage the sale/leaseback of public property is an example of tax policy this country cannot afford. There are many others.

As I said earlier, the people believe tax reform and tax increase are synominous. The people also believe extra taxes paid will create additional spending. Therefore, extra taxes should only be tolerated if the Congress constructs a formula that insures additional taxes collected will reduce the deficit and can not be spent otherwise.

As to the subject of agricultural policy and help for farmers/ranchers: the logic for immediate aid is overwhelming. New York City was aided in it's time of need. Chrysler was supported. The nations banks have hundreds of billions in bad foreign debts that the government will service, perhaps finally absorb. Examples abound.

All of these emergencies would pale compared to the thought of one major American city without food for 3 weeks! At a time when the country enjoys an extra 6 or 8 months supply of food and fiber it is hard to remember the basics: Man can survive without a great many things but food is not one of them.

"Farm" subsidies is a misnomer; money paid to support farm prices at less than the cost of production are "consumer" subsidies. As long as the government manipulates farm prices in any way - foreign policy - money policy - trade policy - whatever - farmers must be given some recognition for being used. The idea that farmers will survive better in a "free trade" atmosphere is moot - there is no free trade.

The fact that about 1% of the people feed the other 99% should be frightening enough to demand action. Certainly if I were one of the other 99 I would feel very vulnerable. If I were the government depending on them to help equalize my balance of payments I would be very protective.

If the produce can be used abroad, farmers should be equitably paid to produce it - if it cannot be used farmers must be supported in removing land from production until the day it will inevitably be needed. Food is more important to any nation than rockets.

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

MONDAY, MARCH 4, 1985

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Chicago, IL.

The committee met, pursuant to recess, at 10:12 a.m., in room 2525, Dirksen Federal Building, 219 South Dearborn, Chicago, IL, Hon. Alan J. Dixon (acting chairman of the committee) presiding.

Present: Senator Dixon.

Staff present: Charles Smith and Karyl Arnold, staff of Senator Dixon; Tom Walsh, tax counsel; Stewart J. Hudson, professional staff member; and Lawrence G. Dalsin, professional staff member.

STATEMENT OF HON. ALAN J. DIXON, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator DIXON. Good morning, ladies and gentlemen.

I would like to begin this morning by welcoming our distinguished group of witnesses and thanking them for taking valuable time off from their busy schedules to be here with us today.

The Senate Small Business Committee is conducting a series of field hearings across the United States exploring the impact of the various tax simplification proposals upon small business. These hearings were requested by the chairman, Senator Lowell Weicker of Connecticut, in conjunction with the ranking member of the Small Business Committee, Senator Dale Bumpers of Arkansas. Hearings have already been held in Tennessee and South Dakota.

Today we will assess the impact of these proposals upon small business in Illinois. Small businesses are the heart of the Illinois economy. There are some 215,876 business establishments in Illinois. Approximately 210,154, or over 97 percent of these business establishments, have fewer than 100 employees, and 156,793, or about 73 percent, have fewer than 10 employees. Key Illinois industries are dominated by small businesses, including contract construction, manufacturing, retailing, insurance and real estate.

I am particularly interested in full employment for our great State. Today Illinois has over 9 percent unemployment. Approximately half of all those employed in Illinois work in business establishments with fewer than 100 people. Eighty percent of new employment in the State comes from small business. Consequently, I see small business as the key to true economic recovery in our State.

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The various proposals for tax simplification have aroused great public concern and interest. One area of agreement nationwide is that the current tax laws are too complex and unfair. Approximately 63 percent of Americans wish to see the Tax Code simplified.

Although there are several tax simplification plans before the Congress, including the Bradley-Gephardt and the Kemp-Kasten bills, the primary focus of today's hearing is the Treasury Department's tax proposal.

The basic goal of the Treasury proposal and other tax simplification proposals is to produce a tax system which is neutral, simple, equitable, and inflation proof.

I support the general goals of tax reform, and I am here today to learn whether small business views these goals and the proposed tax simplification plans as appropriate and workable. No one, for example, objects to the concepts of simplicity and equity in taxes. However, we need to ask whether it is possible for the U.S. tax system to be as simple as the existing plans suggest.

The Treasury proposal itself covers three volumes. Here they are. Furthermore, simplicity and equity can be conflicting goals which will have to be delicately balanced in revising the code. Neutrality in taxation means that the tax system should not affect economic choices. The present tax system is, of course, replete with incentives which affect economic choices.

The proposals for a neutral tax system make the assumption that the Tax Code should not be used to encourage specific activities, whether social or economic. We must determine whether this assumption is valid or whether the U.S. tax system should be used to encourage certain behavior such as savings over consumption.

Now is a particularly opportune time for the country to reexamine the Tax Code. Certain key provisions of the Tax Code, such as the combination of accelerated depreciation and investment tax credits, were created to compensate for high inflation and to stimulate savings.

Given the current low rates of inflation, we must rethink the economic assumptions upon which present policy is based, the objectives which tax policy should foster, and what particular mechanisms should be used to achieve such objectives.

Most of the tax simplification plans share common characteristics. They recognize the need to reduce the effective tax rate, limit the number of tax brackets, equalize the taxation of equals, and broaden the tax base by limiting the number of deductions and credits.

The attempt to broaden the tax base in this manner has unleashed tremendous lobbying efforts by the groups affected. There are significant changes in the Treasury plan concerning investment tax credits, accelerated depreciation, capital gains, changes in the effective tax rate, charitable donations, insurance benefits, business meal deductions, and many others.

The purpose of today's hearing is to develop a record which documents the effect of these proposals upon small business before any legislation is considered.

I am eager to proceed with this hearing, and I am honored to call as our first witness an old friend and distinguished Illinoisan, Lt. Gov. George Ryan. Governor, it is nice to see you again.

STATEMENT OF HON. GEORGE H. RYAN, LIEUTENANT GOVERNOR, STATE OF ILLINOIS

Governor RYAN. It is nice to be here with you, Senator. I appreciate the opportunity.

First of all, I would like to express my appreciation to your committee and your staff for convening this hearing here in Chicago. The committee's efforts to be here and elsewhere throughout the United States should be applauded for it is an indication of your strong commitment to address the concerns of the small business community.

It is a particular pleasure to be with my friends, with you, Senator, whose dedication and service to the people of the State of Illinois should be duly recognized, as I am sure it has.

I would like to take this opportunity, with the committee's presence in Chicago, to convey my thinking about tax simplification, not only from the perspective of an elected official but as a small business owner myself.

As Lieutenant Governor, I was appointed in 1983 to serve as chairman of the Governors Small Business Advisory Council, which continues to seek out the concerns and need of small businesses throughout Illinois. It quickly became apparent that the overwhelming consensus of small business men and women was that they did not want Government programs and Government handouts.

What they wanted most was for Government to get off their backs, to reduce Government regulations and restrictions, to cut back Government spending, and to allow business to return to a true free enterprise system.

We convened a statewide conference last May with some 500 small business owners participating. I believe it is significant that one of the primary recommendations consistent with your purpose here this morning is that the present Tax Code should be simplified. This recommendation was put forth in an effort to ensure that small businesses were not inadvertently forced to bear a disproportionate percentage of the tax burden.

I strongly support their request for tax simplification and welcome your deliberations on the means to provide such reform. I might add that in considering tax simplification, one invariably must look at its impact upon the economy as a whole. I am sure that you would agree their relationship is so interdependent that the change of any one revenue tool will have a rippling effect.

As members of this subcommittee, you are undoubtedly aware of the advantages of promoting and nurturing the development of small business. They number more than 13 million nationally and account for 97 percent of all American companies, and in fact, 40 percent of the gross national product and 60 percent of the employment opportunities stem from small business.

Such statistics are perhaps overwhelming to some and seemingly irrelevant to others. Yet these numbers, which we in Government tend to use, tell a story, I think, about all of us, as a State and as a nation. They tell whether an unemployed person can get a job or own a home or send his child to college.

Within the last 2 years, 7.3 million new jobs have been created in the United States, and most of these jobs were created by small business. Of equal significance, research from the Brookings Institute suggests that small business will create between 50 and 80 percent of all new jobs.

Our primary challenge today is not how to distribute the economic pie but how to enlarge it, and I am encouraged by a recent survey of congressional views which indicates that there is support for significant tax reform. Respondents to the survey rated current tax laws as the most negative legislation affecting small business by a 2-to-1 margin.

As a small businessman, my chief concern is in profits or the maintenance of an adequate margin of return on my investments. To the extent that you want to protect these profit margins, our interests are identical. We have a large stake in the tax revenues which the Federal Government receives. To the extent that any proposal reduces the incentive for investment in small business, our interests stand in delicate balance.

Let me address myself to some of the current concerns which have been illuminated by the Small Business Advisory Council. The current Tax Code is over 5,100 pages long, and there are approximately 10,000 pages of IRS interpretations of that code.

We now have 104 special preferences, and most recent figures indicate that $60 billion were expended to provide taxpayers with professional assistance in the preparation of their return. In this regard, I believe that the Treasury Department's proposal is plausible in its attempt to modify or simplify the vast number of existing deductions and exclusions.

In the wider national interest associated with small business development, I am also suggesting that we need to carefully consider the entrepreneur's interests. It should be mentioned that all of the bills are merely proposals, and when Congress or the administration discuss tax reform, all measures—as I am sure you would agree, Senator—would likely undergo considerable change as they are examined in the lengthy legislative process.

In assessing these proposals, I hope that you will not simplify the Tax Code at the cost of raising rates for small businesses to a unified corporate level. I am pleased that many of the proposals put forth have taken this factor into consideration.

Additionally, I think it is incredibly important that we keep our eye on one significant goal, that of reducing the amount of paperwork which Government currently imposes upon the average taxpayer.

In 1982, the American public spent approximately 2 billion hours to prepare and verify their taxes. Irrespective of this fact, the Internal Revenue Service recently revised existing regulations to create further burdens among the business community with the requirement of auto logs for those seeking an investment tax credit or depreciation of their vehicle when utilized for 100 percent business purposes.

However, Small Business Administration officials and myself remain concerned about the far-reaching ramifications of such regulations. Consider the fact that the requirements was announced with the assertion that only 100,000 individuals would be affected.

Through the research efforts of officials at the SBA, we have found that these figures are substantially inaccurate. There are, in fact, more than 31 million individuals, predominantly small business men and women, who will be affected. I believe that this requirement should be given attention by the Congress in the formulation of any tax reform measure.

Specifically, I think before the Congress goes home in September, we should enact tax simplification which will remedy this paperwork burden, encourage small business investment, while allowing for small- and medium-sized firms to be assessed at a rate consistent with their true earnings. I think that would be good for you; I think it would be good for us in the State government. But, more important than that, I think it would be good for all of the people of the State of Illinois.

Thank you for the opportunity to present this testimony here today and to see you again, Senator. It is nice to be with you.

Senator DIXON. Thank you, Governor.

[The prepared statement of Governor Ryan follows:]

STATEMENT BY: GEORGE H. RYAN, LIEUTENANT GOVERNOR, STATE OF ILLINOIS
BEFORE U.S. SENATE COMMITTEE ON SMALL BUSINESS
MARCH 4, 1985

I want to express my appreciation to the Subcommittee and its staff for convening this hearing in Chicago. The Subcommittee's efforts to meet here and elsewhere throughout the country should be applauded, for it is an indication of your strong commitment to address the concerns of the small business community. It is a particular pleasure to be with one of my friends, Senator Alan Dixon, whose dedication and service to the people of this State should be duly recognized.

I would like to take this opportunity with the Subcommittee's presence in Chicago to convey my thinking about tax simplification, not only from the perspective of a statewide elected official, but as a small business owner myself.

As Lieutenant Governor, I was appointed in 1983 to serve as Chairman of the Governors Small Business Advisory Council which continues to seek out the concerns and needs of small business throughout Illinois. It quickly became apparent that the overwhelming concensus of small businessmen and women was that they did not want new government programs and government handouts. What they wanted most was for government to get off their backs; to reduce government regulations and restrictions; to cutback government spending and to allow business to return to a true free enterprise system.

We convened a statewide conference last May with some five hundred small business owners participating. I believe it is significant that one of the primary recommendations...consistent with your purpose here this morning...is that the present tax code should be simplified. This recommendation was put forth in an effort to ensure that small businesses were not inadvertently forced to bear a disproportionate percentage of the tax burden.

I strongly support their request for tax simplification and welcome your deliberations on the means to provide such reform. I might add that in considering tax simplification, one invariably must look at its impact upon the economy as a whole. I'm sure that you would agree their relationship is so interdependent that the change of one or any revenue tool will have a rippling effect.

As members of this Subcommittee, you are undoubtedly aware of the advantages in promoting and nurturing the development of small business. They number more than 13 million nationally and account for 97% of all American companies. In fact, 40% of the gross national product and sixty percent of all employment opportunities stem from small business.

Such statistics are perhaps overwhelming to some and seemingly irrelevant to others. Yet these numbers, which we in government tend to use, tell a story about all of us...as a state and...as a nation. They tell whether an unemployed person can get a job, own a home, or send his children to college. Within the last two years, 7.3 million new jobs have been created in the United States - and most of these jobs were created by small business. Of equal significance, research from the Brookings Institute suggests that small business will create between 50 and 80 percent of all new jobs.

Our primary challenge today is not how to distribute the economic pie, but how to enlarge it. I am encouraged by a recent survey of Congressional views by Touche Ross which indicates that there is support for significant tax reform. Respondents to the survey rated current tax laws as the most negative legislation affecting small business by a 2 to 1 margin.

As a small businessman, my chief concern is in profits or the maintenance of an adequate margin of return on my investments. To the extent that you want to protect these profit margins our interests are identical, for after all, we have a large stake in the tax revenues which the Federal Government receives. To the extent that any proposal reduces the incentive for investment in small business, our mutual interests stand in delicate balance.

Let me address myself to some of the current concerns which have been illuminated upon by the Small Business Advisory Council. The current tax code is over 5,100 pages long and there are about 10,000 pages of IRS interpretations of that code. We now have 104 special preferences...and most recent figures indicate that 60 billion dollars were expended to provide taxpayers with professional assistance in the preparation of their return. In this regard, I believe that the Treasury Department's proposal is plausible in its attempt to modify or simplify the vast number of existing deductions and exclusions.

In the wider national interests associated with small business development, I am also suggesting that we need to carefully consider the entrepreneurs' interests. It should be mentioned that all of the bills are merely proposals and when Congress or the Administration discusses tax reform...all measures (as I'm sure you would agree) will likely undergo considerable change as they are examined in the lengthy legislative process.

In assessing these proposals, I hope that you will not simplify the tax code at the cost of raising rates for small businesses to a unified corporate level. I am pleased that many of the proposals put forth have taken this factor into consideration.

Additionally, I think it's incredibly important that we keep our eye on one significant goal - that of reducing the amount of paperwork which government currently imposes upon the average taxpayer.

In 1982, the American public spent approximately two billion hours to prepare and verify their taxes. Irrespective of this fact, the Internal Revenue Service recently revised existing regulations to create further burdens among the business community with the requirement of auto logs for those seeking an investment tax credit or depreciation on their vehicle when utilized for 100% business purposes. However, Small Business Administration officials and myself remain concerned about the far reaching ramifications of such regulations. Consider the fact that the requirement was announced with the assertion that only 100,000 individuals would be affected. Through the research efforts of officials at the S.B.A., we have found these figures are substantially inaccurate. There are in fact more than 31 million individuals, predominantly small business men and women who will be affected. I believe that this requirement should be given attention by the Congress in the formulation of any tax reform measure.

Specifically, I think before the Congress goes home in September, we should enact tax simplification which will remedy this paperwork burden...encourage small business investment...while allowing for small and medium sized firms to be assessed at a rate consistent with their true earnings. I think that would be good for you, I think it would be good for us in the State Government. But more important than that, I think it would be good for the people of Illinois.

Thank you very much.

Senator DIXON. Do you know whether the Governors Small Business Advisory Council has a preference at this time for any one of the three different major tax reform proposals that are before us?

Governor RYAN. Sure; we have no specific preference for any specific proposal, whether it is the Treasury's, or Kemp-Kasten, or Bradley-Gephardt, or one of the others under consideration.

However, it appears that there is a clear consensus, I think, among the small business community that some well-intentioned efforts to simplify the Tax Code should not inadvertently increase the tax rate for small businesses. I think we are probably all concerned about that.

I suggest that we continue to expand the tax base so that as the tax expands, there is going to be more revenue even though the rates will continue to come down. I think that is generally the feeling of the Small Business Advisory Council.

But I think one factor that has been lost in this debate is what happened to the tax base of this country since we cut its rates in 1981. It absolutely has expanded, and the council and the small business community will applaud any effort by you or the Congress to bring in the estimated $100 billion in taxes which go unreported as a result of either incomplete reporting or the so-called underground economy.

I think such reform would offer some great hopes for all of us in years ahead, not only to the small business community but for everybody.

So I would be delighted to answer and respond to any questions that you have. The Small Business Advisory Council was reappointed by the Governor this year. Our first meeting is tomorrow, and I will report our activities here today and would be glad to respond to anything that you may have, questions, or supply you with any material that we come up with.

Senator DIXON. I appreciate that, and may I say that as a former distinguished Speaker of the House, you know how these things are done.

Governor RYAN. Right.

Senator DIXON. We have three conflicting proposals that have some similarities, and I am sure there will be extensive hearings in the Finance Committee of the Senate and in the Ways and Means Committee of the House before we ever come to the moment of truth in the Congress. So there is that time for you folk to look at it.

I would like to ask if I could do two things: Send to you—and I would suggest to staff that we send it to you— the simplified explanations of the Treasury proposal, Bradley-Gephardt and Kemp-Kasten, and it will break down, as I have it here, over about a three- or four-page explanation how those particular proposals may differ—for instance, that Treasury replaces the existing 15 rates with 3 rates, essentially 15, 25, and 25 percent; Bradley-Gephardt suggests 14 percent, 26 percent, 30 percent; Kemp-Kasten suggests a 24-percent rate but excludes essentially all income under certain sums.

I thought if you could look at all of that and the variety of different things we do, or these different bills do, with capital gains questions, personal exemptions, accelerated depreciation allowances, investment tax credits, and a lot of things of that character that are important to small businesses; and I would appreciate it if you could visit with the major people in your group about that and give us some responses, category to category, about how you feel on those things.

The second thing that we think is very important, and one of the things that these hearings, hopefully, will ultimately develop, is the view of small business groups such as the Governors Small Business Advisory Council about what they believe the economic impact of either the Treasury proposal or the others might be upon business.

Governor RYAN. We would be delighted to work with you every way that we can, Senator Dixon.

Senator DIXON. In the next week or so, I think I will send along to you, after staff has developed it, those two separate issues, the comparative analysis of the three proposals item by item for your group to look at, and then finally a sort of generic question about what your group thinks the ultimate effect of those proposals might be on business interests.

That, of course, would particularly be the question of taxing fringe benefits such as health plans, the question of the depreciation allowances and things of that kind.

Governor RYAN. I am sure that our commission, after we get organized tomorrow, will have lots of opinions on those kinds of things, as most small business people do. We would be delighted to be able to provide you with that specific information as a result of our planning.

Senator DIXON. It is nice to see you this morning, Governor.

Governor RYAN. I appreciate the opportunity to be with you, and I applaud your efforts, Senator, and wish you well in a tough undertaking, certainly one that is necessary but one that is very tough.

Senator DIXON. Thank you for coming this morning.

Governor RYAN. Thank you.

Senator DIXON. Ladies and gentlemen, the second panel will be Michael Tobin, the chairman of American National Bank and Trust Company of Chicago; and E. Patric Jones, former senior vice president of Hyde Park Bank, president of the Urban Fund of Illinois, and the legislative director for MESBIC Association.

Good morning, gentlemen. Do you have an order of preference? Mr. Tobin, please proceed.

Mr. TOBIN. Thank you.

Senator DIXON. Do you have a prepared text?

Mr. TOBIN. Yes.

Senator DIXON. Thank you. Please go ahead.

STATEMENT OF MICHAEL E. TOBIN, CHAIRMAN OF THE BOARD, AMERICAN NATIONAL BANK OF CHICAGO

Mr. TOBIN. Mr. Chairman and distinguished guests, I am Michael E. Tobin, chairman of the board of the American National Bank of Chicago.

I would like to thank you for this opportunity to present my views on the U.S. Treasury Department's proposal to reform the

Federal tax system. I would also like to commend you and the Senate Small Business Committee on your cross-country tour of inquiry into this proposal's impact on the Nation's small businesses.

We can easily agree that some tax reform is necessary. Our present tax system is so complex that taxpayers spend over $9 billion a year just to prepare their tax returns. But no reform should be enacted without careful review of its overall impact.

The proposals for reform we are discussing today are vast in scope, revolutionary in intent, and far-reaching in consequence. They must be seriously considered from many standpoints, far beyond what we will have time for today.

One important measure of any tax reform proposal is its impact on the overall economy and specifically on small- and middle-sized businesses. These businesses are very important to the American National Bank of Chicago, as our mission is serving their financial needs. The American National Bank of Chicago is the State's fifth largest bank and the largest bank which specializes in serving this market.

Why are these businesses so important? Our typical customer is a closely held manufacturing company with about $10 million in sales, often managed by the entrepreneur who founded the business.

This company will have almost $1 million invested in plant and equipment—approximately one-fourth of its total assets—and from this investment, it will provide employment for 50 to 100 people.

The total profit before tax of a company such as this may well be under $200,000, and often that is reinvested. These are not the mythical "fat cats" often accused of abusing "loopholes" and living high at taxpayer expense. These are hard-working, visionary people who have invested their efforts and savings in their future and, indeed, the future of our free market economy.

They are the backbone of our system. They create more jobs and produce more innovation than their larger counterparts. Even during the 1981-82 recession, small businesses created over 2½ million jobs. In fact, 70 percent of Illinois' work force is employed by small business.

It is crucial to our Nation's continuing economic recovery that Federal policies encourage this vital, job-producing segment of our economy. This is particularly important to the economic viability of Illinois and the Midwest where our climb out of the recession has been slower than that of the rest of the Nation.

During the last recession, Illinois lost almost half a million jobs, over 8 percent of its working population, while the Nation's employment dropped by less than 2 percent. Illinois manufacturers suffered more than most, losing more than 21 percent of their jobs.

But things are improving. We can all see the signs of a burgeoning economy. Business is stronger. Capital investment is increasing. Productivity is rising. Illinois is beginning to regain many of its lost jobs.

Our priority must be to help sustain this blossoming recovery. Any Federal decision must be considered according to its effect on the performance of our Nation's economy.

The economic revitalization of the Nation and its industrial heartland will depend upon a sound Federal fiscal policy which controls Federal spending and ensures continued productivity, capital formation, and the free flow of financial and managerial resources.

The Federal Government is afflicted with two troubling fiscal ailments: A growing budget deficit and a tax structure that many consider as seriously flawed.

The Federal budget deficit for fiscal year 1985 is estimated to be a staggering $220 billion. This has become our Nation's No. 1 economic worry. It overshadows our present and menaces our future.

To quote our President, "Only the threat of indefinitely prolonged high budget deficits threatens the continuation of sustained noninflationary growth and prosperity. It raises the specter of sharply higher interest rates, choked off investment, renewed recession and rising unemployment."

Although there seems to be widespread agreement that the Federal Government faces a serious fiscal problem, there is little consensus over its exact cause and an appropriate cure. Many call for sharp cutbacks in domestic social programs, feeling they have run amuck and are out of gas in terms of effectiveness. Others blame rapidly rising defense spending and recent tax cuts, prescribing sharp reductions in defense programs and increased taxes.

Prudent fiscal policy must address both sides of the fiscal equation—spending and revenue.

Recently, we've seen a great deal of attention directed to the revenue side. The mood for reform is exemplified by the provisions in the Kemp-Kasten "fair and simple tax" proposal, the Gephardt-Bradley "fair" tax proposal, and the Treasury Department's proposal for tax reform. All attempt to simplify our present system while spreading the tax burden more equitably among all payers.

I commend the authors of each of these proposals on their pursuit of an uncomplicated and equitable tax system.

The question at hand is what specific actions are needed and how to go about the complex task of implementation. Let's look at the key elements of tax reform.

Any attempt to improve the Federal Tax Code must simplify what has evolved into a system that is complex, convoluted and contradictory.

Any forward looking Tax Code must help spur savings and investment because savings and investment drive economic growth.

Equally important, tax reform must be achieved without economic upheaval.

This review raises several important questions that I urge you to seriously consider in your deliberations. First, we must ask ourselves whether our Nation's economy can withstand the impact of sudden and dramatic change. While our economy appears poised for unprecedented growth, it is still vulnerable, with many sectors in deep trouble.

The Treasury Department's proposal completely overhauls the Federal tax system, disrupting decades of planning and investment. However well intentioned or worthwhile, abruptly executed tax reform will result in economic chaos.

Even the hint of change is already affecting investment decisions. Many companies are reconsidering or postponing their capital investment plans as they wait to see what happens. As an example, we saw capital goods investment drop by 11 percent in January. I am very concerned about what would occur if these changes were enacted in a wide-sweeping and sudden manner.

Any reform must be gradually phased in to allow businesses and individual investors adequate time to gradually alter their investment patterns. Without an orderly transition period, investment will be shifted abruptly, resulting in massive dislocations, increased unemployment and economic distress.

The Midwest could not weather such a blow without devastating consequences. Our economic recovery, while strengthening, is still fragile. The turbulence that would follow such wide-sweeping and sudden changes could far outweigh the benefits that would otherwise have been brought about by thoughtfully implemented reform. We must remember that the way in which we get to tax reform is as important as achieving the goal.

The second question we must ask ourselves when considering tax reform is whether it will help or hinder capital formation.

The Treasury proposal eliminates many investment incentives, such as the accelerated cost recovery system and the investment tax credit, that were enacted for the express purpose of spurring capital investment. The elimination of these incentives will have serious consequences for Illinois and the Midwest.

Our industrialized economy, with its capital-intensive industries, will be hit particularly hard by this provision. It seems incongruous that Treasury wants to remove these incentives as they have been responsible, in part, for our improved economy.

Let's examine the effect of removing these incentives on a typical American National Bank customer. Remember that our profiled customer is a privately held company with $10 million in sales. Many are manufacturers. Most, we hope, are growing.

Growth for a manufacturer requires capital investment in machinery, equipment, or perhaps an expanded facility. These investments are required when a firm wants to start a new product line, expand its operations, or when it simply needs to modernize in order to remain competitive.

These firms will be hurt by lengthening the period of depreciation and repealing the investment tax credit. Matching depreciation to the actual life of an investment will reduce a company's cash-flow and ability to make future investments. Revoking the investment tax credit will further reduce cash-flow and the working capital needed to support an ongoing investment.

We estimate that these changes in deductions, coupled with indexing interest expenses and instituting a flat corporate rate, could double a small company's taxes. Indeed, our rough calculations show that a small manufacturer's tax liability would increase significantly, earnings would decrease, and cash-flow would deteriorate under the Treasury's proposal.

Clearly, the incentives provided by our present tax system are necessary for capital formation. Without adequate capital, Illinois economic recovery, which is struggling to catch up to that of the Nation, could revert back to where we were during the last recession.

I have similar concerns about other provisions in the Treasury Department's proposal as well. Eliminating the favorable treatment of capital gains will alter investment patterns significantly, drastically shrinking the investment capital that has helped to fuel our economic recovery.

Taxing of capital gains as ordinary income will steer investors away from long-term capital investments. This will hurt all companies but particularly new and emerging businesses. These firms don't have the internal capital-generating resources found in larger companies and must rely on the marketplace for capital in order to grow. If there is no capital for long-term investment, small companies, our prime generator of jobs, will lack the fuel they need to grow.

Changing the taxation of capital gains also will hinder our competitiveness with foreign companies. Most countries with whose firms we compete encourage capital formation by favoring capital gains with very low or no taxes.

All of these provisions—slowing depreciation, repealing the investment tax credit, taxing at single corporate rate, indexing interest deductions for inflation, and no longer favoring capital gains—all could have a perilous effect on small- and medium-sized businesses and on our overall economy.

And these are only a few of the provisions in the Treasury Department's proposal which will significantly affect job creation and economic growth.

Senator DIXON. Could I interrupt you, Mr. Tobin, at that point for a second?

Mr. TOBIN. Yes, sir.

Senator DIXON. A number of times, you have referred in your statement here so far to the Treasury Department's proposal, which is the one we are working from. But the points you have just made about investment tax credits and the ACRS [accelerated cost recovery system] would apply to all the bills, would they not, in general?

Mr. TOBIN. We have not made a particular study of all the bills, Senator.

Senator DIXON. I see people behind you. I would like to get that in the record.

Mr. TOBIN. That is correct, yes.

Senator DIXON. Now, for the record, then, while you are reporting on your attitude about the Treasury Department proposal, I think the record ought to show that all three do repeal the investment tax credit, Bradley-Gephardt and Kemp-Kasten, and while the ACRS is treated differently in the three systems, all essentially change it from the present system, so if you don't mind, I would like the record to show that what you are saying would in fact refer to all three different plans.

Mr. TOBIN. Yes, indeed, I would agree.

Senator DIXON. All right, thank you.

Please proceed.

Mr. TOBIN. My greatest concern is enacting reform without a complete understanding of its economic consequences. What is the value of reform if it jeopardizes our economic viability and particularly that of or industrialized regions and their manufacturing sector?

The final question I would like to raise with you today is whether the current focus on tax reform will divert our attention from our most pressing fiscal problem, the Federal budget deficit.

The Federal deficit contributes to higher real interest rates which stifles investment and threatens our economic future. Many argue that the rise in interest rates increases the value of the dollar in the international exchange markets. A strong dollar makes our exports less attractive and less price competitive and imported goods more attractive to U.S. consumers, widening our international trade deficit.

This significantly hurts the economy of Illinois and the Midwest. Many of our major industries, which have historically relied upon major export markets, and which today are confronting significant import competition, are finding that the high value of the dollar has rendered them uncompetitive. This is a major reason that many parts of our economy have not participated in our current recovery.

Our Federal budget deficit must be reduced. Federal spending on domestic and defense programs alike must be restrained. If spending reductions cannot sufficiently diminish the deficit and tax increases are necessary, then these hikes must be implemented in a manner consistent with continued economic recovery and growth.

In the past few minutes, I have outlined my views on the various proposals for tax reform being considered by Congress today. Tax reform is a worthy goal, and I support Congress in its pursuit of a simple and equitable Federal tax system.

But there are issues before us which transcend simplicity. I urge you to consider the economic consequences of these proposals as part of your deliberations. Far more is at stake than how taxes are paid. Dramatic changes in the tax system will have a dramatic impact on the overall economy and individual businesses. We must be assured that these changes will sustain and not derail the economic recovery of the United States and the Midwest.

Again, I commend the members of the committee for taking an active interest in small and medium-sized businesses in Illinois and the Midwest. As an advocate for this group, I stand ready to help you in your efforts to bring about simple and equitable tax reform.

Thank you.

[The prepared statement of Mr. Tobin follows:]

Statement of Michael E. Tobin, Chairman of the Board, American National Bank of Chicago

MR. CHAIRMAN AND DISTINGUISHED GUESTS:

I AM MICHAEL E. TOBIN, CHAIRMAN OF THE BOARD OF THE AMERICAN NATIONAL BANK OF CHICAGO. I WOULD LIKE TO THANK YOU FOR THIS OPPORTUNITY TO PRESENT MY VIEWS ON THE U.S. TREASURY DEPARTMENT'S PROPOSAL TO REFORM THE FEDERAL TAX SYSTEM. I WOULD ALSO LIKE TO COMMEND YOU AND THE SENATE SMALL BUSINESS COMMITTEE ON YOUR CROSS-COUNTRY TOUR OF INQUIRY INTO THIS PROPOSAL'S IMPACT ON THE NATION'S SMALL BUSINESSES.

WE CAN EASILY AGREE THAT SOME TAX REFORM IS NECESSARY. OUR PRESENT SYSTEM IS SO COMPLEX THAT TAXPAYERS SPEND OVER $9 BILLION JUST TO PREPARE THEIR RETURNS EACH YEAR. BUT NO REFORM SHOULD BE ENACTED WITHOUT CAREFUL REVIEW OF ITS OVERALL IMPACT. THE PROPOSALS FOR REFORM WE ARE DISCUSSING TODAY ARE VAST IN SCOPE, REVOLUTIONARY IN INTENT AND FAR REACHING IN CONSEQUENCE. THEY MUST BE SERIOUSLY CONSIDERED FROM MANY STANDPOINTS, FAR BEYOND WHAT WE WILL HAVE TIME FOR TODAY.

ONE IMPORTANT MEASURE OF ANY TAX REFORM PROPOSAL IS ITS IMPACT ON THE OVERALL ECONOMY AND SPECIFICALLY ON SMALL AND MIDDLE-SIZED BUSINESSES.

THESE BUSINESSES ARE VERY IMPORTANT TO THE AMERICAN NATIONAL BANK OF CHICAGO AS OUR MISSION IS SERVING THEIR FINANCIAL NEEDS. THE AMERICAN NATIONAL BANK OF CHICAGO IS THE STATE'S FIFTH LARGEST BANK AND THE LARGEST BANK WHICH SPECIALIZES IN SERVING THIS MARKET.

WHY ARE THESE BUSINESSES SO IMPORTANT? OUR TYPICAL CUSTOMER IS A CLOSELY HELD MANUFACTURING COMPANY WITH ABOUT $10 MILLION IN SALES, OFTEN MANAGED BY THE ENTREPRENEUR WHO FOUNDED THE BUSINESS. THIS COMPANY WILL HAVE ALMOST $1 MILLION INVESTED IN PLANT AND EQUIPMENT; APPROXIMATELY ONE FOURTH OF ITS TOTAL ASSETS. AND FROM THIS INVESTMENT, IT WILL PROVIDE EMPLOYMENT FOR 50-100 PEOPLE.

THE TOTAL PROFIT BEFORE TAX OF A COMPANY SUCH AS THIS MAY WELL BE UNDER $200,000, AND OFTEN THAT IS RE-INVESTED. THESE ARE NOT THE MYTHICAL "FAT CATS", OFTEN ACCUSED OF ABUSING "LOOPHOLES" AND LIVING HIGH AT TAXPAYER EXPENSE. THESE ARE HARD-WORKING, VISIONARY PEOPLE WHO HAVE INVESTED THEIR EFFORTS AND SAVINGS IN THEIR FUTURE, AND INDEED IN THE FUTURE OF OUR FREE-MARKET ECONOMY. THEY ARE THE BACKBONE OF OUR SYSTEM. THEY CREATE MORE JOBS AND PRODUCE MORE INNOVATION THAN THEIR LARGER COUNTERPARTS. EVEN DURING THE 1981-82 RECESSION, SMALL BUSINESSES CREATED OVER 2 1/2 MILLION JOBS. IN FACT, 70 PERCENT OF ILLINOIS' WORKFORCE IS EMPLOYED BY SMALL BUSINESS.

IT IS CRUCIAL TO OUR NATION'S CONTINUING ECONOMIC RECOVERY THAT FEDERAL POLICIES ENCOURAGE THIS VITAL, JOB-PRODUCING SEGMENT OF OUR ECONOMY.

THIS IS PARTICULARLY IMPORTANT TO THE ECONOMIC VIABILITY OF ILLINOIS AND THE MIDWEST WHERE OUR CLIMB OUT OF THE RECESSION HAS BEEN SLOWER THAN THAT OF THE REST OF THE NATION.

DURING THE LAST RECESSION, ILLINOIS LOST ALMOST HALF A MILLION JOBS, OVER 8 PERCENT OF ITS WORKING POPULATION, WHILE THE NATION'S EMPLOYMENT DROPPED BY LESS THAN 2 PERCENT. ILLINOIS MANUFACTURERS SUFFERED MORE THAN MOST, LOSING MORE THAN 21 PERCENT OF THEIR JOBS.

BUT THINGS ARE IMPROVING. WE CAN ALL SEE THE SIGNS OF A BURGEONING ECONOMY. BUSINESSES ARE STRONGER. CAPITAL INVESTMENT IS INCREASING. PRODUCTIVITY IS RISING. ILLINOIS IS BEGINNING TO REGAIN MANY OF ITS LOST JOBS.

OUR PRIORITY MUST BE TO HELP SUSTAIN THIS BLOSSOMING RECOVERY. ANY FEDERAL DECISION MUST BE CONSIDERED ACCORDING TO ITS EFFECT ON THE PERFORMANCE OF OUR NATION'S ECONOMY.

THE ECONOMIC REVITALIZATION OF THE NATION AND ITS INDUSTRIAL HEARTLAND WILL DEPEND UPON A SOUND FEDERAL FISCAL POLICY WHICH CONTROLS FEDERAL SPENDING AND ENSURES CONTINUED PRODUCTIVITY, CAPITAL FORMATION, AND THE FREE FLOW OF FINANCIAL AND MANAGERIAL RESOURCES.

THE FEDERAL GOVERNMENT IS AFFLICTED WITH TWO TROUBLING FISCAL AILMENTS: A GROWING BUDGET DEFICIT AND A TAX STRUCTURE THAT MANY VIEW AS SERIOUSLY FLAWED.

THE FEDERAL BUDGET DEFICIT FOR FISCAL YEAR 1985 IS ESTIMATED TO BE A STAGGERING $220 BILLION. THIS HAS BECOME OUR NATION'S NUMBER ONE ECONOMIC WORRY. IT OVERSHADOWS OUR PRESENT AND MENACES OUR FUTURE. TO QUOTE OUR PRESIDENT:

> "ONLY THE THREAT OF INDEFINITELY PROLONGED HIGH BUDGET DEFICITS THREATENS THE CONTINUATION OF SUSTAINED NON-INFLATIONARY GROWTH AND PROSPERITY. IT RAISES THE SPECTER OF SHARPLY HIGHER INTEREST RATES, CHOKED OFF INVESTMENT, RENEWED RECESSION AND RISING UNEMPLOYMENT."

ALTHOUGH THERE SEEMS TO BE WIDESPREAD AGREEMENT THAT THE FEDERAL GOVERNMENT FACES A SERIOUS FISCAL PROBLEM, THERE IS LITTLE CONSENSUS OVER ITS EXACT CAUSES AND AN APPROPRIATE CURE. MANY CALL FOR SHARP CUTBACKS IN DOMESTIC SOCIAL PROGRAMS, FEELING THEY HAVE RUN AMUCK AND ARE OUT OF GAS IN TERMS OF EFFECTIVENESS. OTHERS BLAME RAPIDLY RISING DEFENSE SPENDING AND RECENT TAX CUTS, PRESCRIBING SHARP REDUCTIONS IN DEFENSE PROGRAMS AND INCREASED TAXES.

PRUDENT FISCAL POLICY MUST ADDRESS BOTH SIDES OF THE FISCAL EQUATION - SPENDING AND REVENUE.

RECENTLY, WE'VE SEEN A GREAT DEAL OF ATTENTION DIRECTED TO THE REVENUE SIDE. THIS MOOD FOR REFORM IS EXEMPLIFIED BY THE PROVISIONS IN THE KEMP-KASTEN "FAIR AND SIMPLE TAX" PROPOSAL, THE GEPHARDT-BRADLEY "FAIR" TAX PROPOSAL, AND THE TREASURY DEPARTMENT'S PROPOSAL FOR TAX REFORM. ALL ATTEMPT TO SIMPLIFY OUR PRESENT SYSTEM WHILE SPREADING THE TAX BURDEN MORE EQUITABLY AMONG ALL PAYERS.

I COMMEND THE AUTHORS OF EACH OF THESE PROPOSALS ON THEIR PURSUIT OF AN UNCOMPLICATED AND EQUITABLE TAX SYSTEM.

THE QUESTION AT HAND IS WHAT SPECIFIC ACTIONS ARE NEEDED AND HOW TO GO ABOUT THE COMPLEX TASK OF IMPLEMENTATION. LET'S LOOK AT THE KEY ELEMENTS OF TAX REFORM.

ANY ATTEMPT TO IMPROVE THE FEDERAL TAX CODE MUST SIMPLIFY WHAT HAS EVOLVED INTO A SYSTEM THAT IS COMPLEX, CONVOLUTED AND CONTRADICTORY.

ANY FORWARD LOOKING TAX CODE MUST HELP SPUR SAVINGS AND INVESTMENT BECAUSE SAVINGS AND INVESTMENT DRIVE ECONOMIC GROWTH.

EQUALLY IMPORTANT, TAX REFORM MUST BE ACHIEVED WITHOUT ECONOMIC UPHEAVAL.

THIS REVIEW RAISES SEVERAL IMPORTANT QUESTIONS THAT I URGE YOU TO SERIOUSLY CONSIDER IN YOUR DELIBERATIONS.

FIRST, WE MUST ASK OURSELVES WHETHER OUR NATION'S ECONOMY CAN WITHSTAND THE IMPACT OF SUDDEN AND DRAMATIC CHANGE. WHILE OUR ECONOMY APPEARS POISED FOR UNPRECEDENTED GROWTH, IT IS STILL VULNERABLE WITH MANY SECTORS IN DEEP TROUBLE.

THE TREASURY DEPARTMENT'S PROPOSAL COMPLETELY OVERHAULS THE FEDERAL TAX SYSTEM, DISRUPTING DECADES OF PLANNING AND INVESTMENT. HOWEVER WELL INTENDED OR WORTHWHILE, ABRUPTLY EXECUTED TAX REFORM WILL RESULT IN ECONOMIC CHAOS.

EVEN THE HINT OF CHANGE IS ALREADY AFFECTING INVESTMENT DECISIONS. MANY COMPANIES ARE RECONSIDERING OR POSTPONING THEIR CAPITAL INVESTMENT PLANS AS THEY WAIT TO SEE WHAT HAPPENS. AS AN EXAMPLE, WE SAW CAPITAL GOODS INVESTMENT DROP BY 11 PERCENT IN JANUARY. I AM VERY CONCERNED ABOUT WHAT WOULD OCCUR IF THESE CHANGES WERE ENACTED IN A WIDE-SWEEPING AND SUDDEN MANNER!

ANY REFORM MUST BE GRADUALLY PHASED IN TO ALLOW BUSINESSES AND INDIVIDUAL INVESTORS ADEQUATE TIME TO GRADUALLY ALTER THEIR INVESTMENT PATTERNS. WITHOUT AN ORDERLY TRANSITION PERIOD, INVESTMENT WILL BE SHIFTED ABRUPTLY, RESULTING IN MASSIVE DISLOCATIONS, INCREASED UNEMPLOYMENT AND ECONOMIC DISTRESS.

THE MIDWEST COULD NOT WEATHER SUCH A BLOW WITHOUT DEVASTATING CONSEQUENCES. OUR ECONOMIC RECOVERY, WHILE STRENGTHENING, IS STILL FRAGILE. THE TURBULENCE THAT WOULD FOLLOW SUCH WIDE-SWEEPING AND SUDDEN CHANGES COULD FAR OUTWEIGH THE BENEFITS THAT WOULD OTHERWISE HAVE BEEN BROUGHT ABOUT BY THOUGHTFULLY IMPLEMENTED REFORM. WE MUST REMEMBER THAT THE WAY IN WHICH WE GET TO TAX REFORM IS AS IMPORTANT AS ACHIEVING THE GOAL.

THE SECOND QUESTION WE MUST ASK OURSELVES WHEN CONSIDERING TAX REFORM IS WHETHER IT WILL HELP OR HINDER CAPITAL FORMATION.

THE TREASURY PROPOSAL ELIMINATES MANY INVESTMENT INCENTIVES, SUCH AS THE ACCELERATED COST RECOVERY SYSTEM AND THE INVESTMENT TAX CREDIT, THAT WERE ENACTED FOR THE EXPRESS PURPOSE OF SPURRING CAPITAL INVESTMENT. THE ELIMINATION OF THESE INCENTIVES WILL HAVE SERIOUS CONSEQUENCES FOR ILLINOIS AND THE MIDWEST. OUR INDUSTRIALIZED ECONOMY, WITH ITS CAPITAL INTENSIVE INDUSTRIES, WILL BE HIT PARTICULARLY HARD BY THIS PROVISION. IT SEEMS INCONGRUOUS THAT TREASURY WANTS TO REMOVE THESE INCENTIVES AS THEY HAVE BEEN RESPONSIBLE, IN PART, FOR OUR IMPROVED ECONOMY.

LET'S EXAMINE THE EFFECT OF REMOVING THESE INCENTIVES ON A TYPICAL AMERICAN NATIONAL BANK CUSTOMER. REMEMBER THAT OUR PROFILED CUSTOMER IS A PRIVATELY HELD COMPANY WITH $10 MILLION IN SALES. MANY ARE MANUFACTURERS. MOST, WE HOPE, ARE GROWING.

GROWTH FOR A MANUFACTURER REQUIRES CAPITAL INVESTMENT IN MACHINERY, EQUIPMENT OR PERHAPS AN EXPANDED FACILITY. THESE INVESTMENTS ARE REQUIRED WHEN A FIRM WANTS TO START A NEW PRODUCT LINE, EXPAND ITS OPERATIONS OR WHEN IT SIMPLY NEEDS TO MODERNIZE IN ORDER TO REMAIN COMPETITIVE.

THESE FIRMS WILL BE HURT BY LENGTHENING THE PERIOD OF DEPRECIATION AND REPEALING THE INVESTMENT TAX CREDIT. MATCHING DEPRECIATION TO THE ACTUAL LIFE OF AN INVESTMENT WILL REDUCE A COMPANY'S CASH FLOW AND ABILITY TO MAKE FUTURE INVESTMENTS. REVOKING THE INVESTMENT TAX CREDIT WILL FURTHER REDUCE CASH FLOW AND THE WORKING CAPITAL NEEDED TO SUPPORT ON-GOING INVESTMENT.

WE ESTIMATE THAT THESE CHANGES IN DEDUCTIONS, COUPLED WITH INDEXING INTEREST EXPENSES AND INSTITUTING A FLAT CORPORATE RATE, COULD DOUBLE A SMALL COMPANY'S TAXES. INDEED OUR ROUGH CALCULATIONS SHOW THAT A SMALL MANUFACTURER'S TAX LIABILITY WOULD INCREASE SIGNIFICANTLY, EARNINGS WOULD DECREASE, AND CASH FLOW DETERIORATE UNDER THE TREASURY'S PROPOSAL.

CLEARLY THE INCENTIVES PROVIDED BY OUR PRESENT TAX SYSTEM ARE NECESSARY FOR CAPITAL FORMATION. CAPITAL FORMATION MEANS GROWTH AND GROWTH MEANS JOBS. WITHOUT ADEQUATE CAPITAL, ILLINOIS' ECONOMIC RECOVERY, WHICH IS STRUGGLING TO CATCH UP TO THAT OF THE NATION'S, COULD REVERT BACK TO WHERE WE WERE DURING THE LAST RECESSION.

I HAVE SIMILAR CONCERNS ABOUT OTHER PROVISIONS IN THE TREASURY DEPARTMENT'S PROPOSAL AS WELL.

ELIMINATING THE FAVORABLE TREATMENT OF CAPITAL GAINS WILL ALTER INVESTMENT PATTERNS SIGNIFICANTLY, DRASTICALLY SHRINKING THE INVESTMENT CAPITAL THAT HAS HELPED TO FUEL OUR ECONOMIC RECOVERY.

TAXING OF CAPITAL GAINS AS ORDINARY INCOME WILL STEER INVESTORS AWAY FROM LONG TERM CAPITAL INVESTMENTS. THIS WILL HURT ALL COMPANIES, BUT PARTICULARLY OUR NEW AND EMERGING BUSINESSES. THESE FIRMS DON'T HAVE THE INTERNAL CAPITAL GENERATING RESOURCES FOUND IN LARGER COMPANIES AND MUST RELY ON THE MARKETPLACE FOR CAPITAL IN ORDER TO GROW. IF THERE IS NO CAPITAL FOR LONG TERM INVESTMENT, SMALL COMPANIES, OUR PRIME GENERATOR OF JOBS, WILL LACK THE FUEL THEY NEED TO GROW.

CHANGING THE TAXATION OF CAPITAL GAINS ALSO WILL HINDER OUR COMPETITIVENESS WITH FOREIGN COMPANIES. MOST COUNTRIES WITH WHOSE FIRMS WE COMPETE ENCOURAGE CAPITAL FORMATION BY FAVORING CAPITAL GAINS WITH VERY LOW OR NO TAXES.

ALL OF THESE PROVISIONS - SLOWING DEPRECIATION, REPEALING THE INVESTMENT TAX CREDIT, TAXING AT SINGLE CORPORATE RATE, INDEXING INTEREST DEDUCTIONS FOR INFLATION, AND NO LONGER FAVORING CAPITAL GAINS ALL COULD HAVE A PERILOUS ~~A~~EFFECT ON SMALL AND MEDIUM-SIZED BUSINESSES AND ON OUR OVERALL ECONOMY. AND THESE ARE ONLY A FEW OF THE PROVISIONS IN THE TREASURY DEPARTMENT'S PROPOSAL WHICH WILL SIGNIFICANTLY AFFECT JOB CREATION AND ECONOMIC GROWTH. I DO NOT HAVE TIME TO DISCUSS ALL OF THEM; BUT THEY MUST BE CONSIDERED THOROUGHLY AND CAREFULLY. MY GREATEST CONCERN IS ENACTING REFORM WITHOUT A COMPLETE UNDERSTANDING OF ITS ECONOMIC CONSEQUENCES. WHAT IS THE VALUE OF REFORM IF IT JEOPARDIZES OUR ECONOMIC VIABILITY AND PARTICULARLY THAT OF OUR INDUSTRIALIZED REGIONS AND THEIR MANUFACTURING SECTOR?

THE FINAL QUESTION I WOULD LIKE TO RAISE WITH YOU TODAY IS WHETHER THE CURRENT FOCUS ON TAX REFORM WILL DIVERT OUR ATTENTION FROM OUR MOST PRESSING FISCAL PROBLEM: THE FEDERAL BUDGET DEFICIT.

THE FEDERAL DEFICIT CONTRIBUTES TO HIGHER REAL INTEREST RATES WHICH STIFLES AN INVESTMENT AND THREATENS OUR ECONOMIC FUTURE. MANY ARGUE THAT THE RISE IN INTEREST RATES INCREASES THE VALUE OF THE DOLLAR IN THE INTERNATIONAL EXCHANGE MARKETS. A STRONG DOLLAR MAKES OUR EXPORTS LESS PRICE COMPETITIVE AND IMPORTED GOODS MORE ATTRACTIVE TO U.S. CONSUMERS, WIDENING OUR INTERNATIONAL TRADE DEFICIT.

THIS SIGNIFICANTLY HURTS THE ECONOMY OF ILLINOIS AND THE MIDWEST. MANY OF OUR MAJOR INDUSTRIES, WHICH HAVE HISTORICALLY RELIED UPON MAJOR EXPORT MARKETS AND WHICH TODAY ARE CONFRONTING SIGNIFICANT IMPORT COMPETITION, ARE FINDING THAT THE HIGH VALUE OF THE DOLLAR HAS RENDERED THEM UNCOMPETITIVE. THIS A MAJOR REASON THAT MANY PARTS OF OUR ECONOMY HAVEN'T PARTICIPATED IN OUR CURRENT RECOVERY.

OUR FEDERAL BUDGET DEFICIT MUST BE REDUCED. FEDERAL SPENDING ON DOMESTIC AND DEFENSE PROGRAMS ALIKE MUST BE RESTRAINED. IF SPENDING REDUCTIONS CAN'T SUFFICIENTLY DIMINISH THE DEFICIT AND TAX INCREASES ARE NEEDED, THEN THESE HIKES MUST BE IMPLEMENTED IN A MANNER CONSISTENT WITH CONTINUED ECONOMIC RECOVERY AND GROWTH.

IN THE PAST FEW MINUTES I HAVE OUTLINED MY VIEWS ON THE VARIOUS PROPOSALS FOR TAX REFORM BEING CONSIDERED BY CONGRESS TODAY. TAX REFORM IS A WORTHY GOAL AND I SUPPORT CONGRESS IN ITS PURSUIT OF A SIMPLE AND EQUITABLE FEDERAL TAX SYSTEM.

BUT THERE ARE ISSUES BEFORE US WHICH TRANSCEND SIMPLICITY. I URGE YOU TO CONSIDER THE ECONOMIC CONSEQUENCES OF THESE PROPOSALS AS PART OF YOUR DELIBERATIONS. FAR MORE IS AT STAKE THAN HOW TAXES ARE PAID. DRAMATIC CHANGES IN THE TAX SYSTEM WILL HAVE A DRAMATIC IMPACT ON THE OVERALL ECONOMY AND INDIVIDUAL BUSINESSES. WE MUST BE ASSURED THAT THESE CHANGES WILL SUSTAIN AND NOT DERAIL THE ECONOMIC RECOVERY OF THE U.S. AND THE MIDWEST.

AGAIN, I COMMEND THE MEMBERS OF THE COMMITTEE FOR TAKING AN ACTIVE INTEREST IN SMALL AND MEDIUM-SIZED BUSINESSES IN ILLINOIS AND THE MIDWEST. AS AN ADVOCATE FOR THIS GROUP, I STAND READY TO HELP YOU IN YOUR EFFORTS TO BRING ABOUT SIMPLE AND EQUITABLE TAX REFORM.

THANK YOU.

Senator DIXON. Thank you. May I ask you a couple of questions before I go on to Mr. Jones, if you don't mind, Mr. Tobin?

Incidentally, let the record show before this time that Bill Stowe from the Illinois State Chamber of Commerce was in the room this morning. He has prepared a written statement on behalf of the chamber and has requested that it be placed in the record, and I want to express the appreciation of this committee for his testimony, and I want the record to show that Mr. Stowe's statement will be reproduced in the record as though given.

[The prepared statement of Mr. Stowe follows:]

Illinois State Chamber of Commerce

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Chicago, Illinois 60606
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TAX SIMPLIFICATION -- SMALL BUSINESS

Testimony to the U. S. Senate Committee on Small Business by William E. Stowe, Manager, Tax Department, Illinois State Chamber of Commerce, 20 North Wacker Drive, Chicago 60606 (219 S. Dearborn, March 4, 1985).

The State Chamber is the largest business association in the State of Illinois. Our membership of more than 12,000 men and women represent nearly 6000 businesses of every size -- large and small -- engaged in all types of commerce and industry throughout the state. About 80% of our members are small or medium sized businesses.

For more than sixty-five years, we have endeavored to provide an organized collective voice for the concerns of the business community of this state. Our major concern has always been to advocate, create and maintain a favorable business climate. This is the key to economic growth, increased personal income, and expanded job opportunities for our work force.

About a year ago, President Reagan asked the Treasury Department to recommend changes in the federal tax system designed to reform and simplify the system, and to do so without increasing taxes, i.e. to be revenue neutral. Treasury's response report, "Tax Reform for Fairness, Simplicity, and Economic Growth" achieves the required revenue neutrality in a strange fashion. Over a 5 year period corporate tax liabilities would rise from 25-37%, costing business about $165 billion during that time, according to one estimate; individuals would find their liabilities reduced a similar amount. Revenue neutral in this case has come to mean holding about 80% of individual taxpayers harmless from any significant change while radically increasing corporate liabilities to target lower taxes for low income individuals. This distortion of revenue neutrality is neither fair, simple or encouraging for economic growth. The report triggers a gigantic shift of tax burden away from individuals and onto business. Further, it comes on the heels of the largest reduction in individual income taxes ever enacted.

Illinois is a manufacturing state -- a part of "smokestack America." Thus, we are a state whose recovery from the recent recession will be severely damaged by changes designed not only to increase the corporate tax burden, but to rearrange that burden among industries, penalizing capital intensive businesses. This is done, in the Treasury proposal by repealing the investment credit (ITC) and the accelerated cost recovery system of depreciation (ACRS). Both of these provisions have been invaluable to the small, capital intensive businesses -- a view that is supported by the U. S. Small Business Administration.

Investment credit in place since 1962 and expanded throughout its term, is generally credited with stimulating the level of capital investment -- including small business capital investment -- so necessary in maintaining and expanding the job market. ACRS, to the small business man -- particularly in manufacturing states like Illinois. In addition to ACRS and ITC, this means that preferential rates for capital gains and for the first $150,000 taxable income, along with first year expensing for $10,000 of capital investment should be in the system. Finally, the administrative, fiscal and economic problems created by forcing states like Illinois to de-couple or to reduce rates in order to maintain stable and predictable systems at the state level, should not be underestimated.

The State Chamber wants to continue to work closely with the Senate Committee on Small Business to achieve and maintain a tax system which will meet our requirements for revenues while permitting and encouraging the growth so vital to our state and nation.

Senator DIXON. Is it a correct characterization of all you have said here, Mr. Tobin, that, at least from your perspective, you believe that the higher priority is to go into the question of doing something about the budgetary deficit before we come to the question of what is euphemistically referred to as tax reformation?

Mr. TOBIN. I believe both are of considerable importance. If I had to ascribe a priority of one over the other, any such priority would be very slight indeed. Both, to me, are extremely important.

Senator DIXON. My sense of what you have said in your whole statement is that you think that tax simplification is very important, but you think that there are some very serious economic down sides to some of the things that are contemplated in all of these proposals that need careful analysis so that the Congress and the administration are very sure that what they ultimately do does not create serious economic difficulties in the business community. Is that a fair characterization of your testimony?

Mr. TOBIN. Yes, sir. I would say that when one deals with tax reform, one is dealing with an enormously complex issue. It has many parts; one part interacts with another; and what in effect we have is, to my way of thinking, one of the most complex models, econometric models, that one can conceive.

In dealing with this, if you will give me my assumption that some basic change is needed, how one treats a particular area, the area we were concentrating on today—the impact on the smaller business group—how one treats this, one must handle it very gingerly, it seems to me. The impacts can be deep and wide.

Also, when one changes the structure of the tax system, I think, an overwhelming amount of consideration must be given to phasing in rather than creating abrupt change. Abrupt change in itself I see, even if it is pursued toward a good end, could have a very catastrophic impact.

Senator DIXON. And you say on page 6, in connection with a couple of paragraphs here that I think are significant— paragraphs 1 and 2 on page 6—you conclude by saying: "Abruptly executed tax reform will result in economic chaos."

Is that a carefully thought out statement? Do you really believe that?

Mr. TOBIN. Yes, sir; I think, as an indication of what I am talking about here, one need go only to what has been produced in the way of investment decisions already.

Senator DIXON. Well, I notice that you point out—if I may interrupt—that in January you saw capital goods investment drop by 11 percent. I think it is the clear implication, at least, in what you say here that you believe what we are discussing has caused some reluctance in the marketplace.

Mr. TOBIN. Precisely.

Senator DIXON. I want to say to you that, for instance, homebuilders, people in the real estate investment business, have been telling some of us those same things. Do you see that occurring? They are saying that there is actually a reluctance to make investments predicated on what could happen.

Mr. TOBIN. Absolutely, and I had in mind, in part, the real estate group in making that comment.

Senator DIXON. Some of us have thought out loud about some of these things being considered, when they ultimately are considered, on a prospective basis. If the investment community knew that, would that help, from the standpoint of what some of us are hearing is a dampening effect out there already, if the investment community knew that whatever was going to happen would be prospective?

Mr. TOBIN. By prospective sir, I assume you have in mind a phasein period?

Senator DIXON. Yes, maybe that, or even some kind of a cutoff period, saying that what had occurred prior to that time, that you could continue the depreciation of things of that character.

Mr. TOBIN. I think, if I am understanding you correctly, a statement to the effect that we are considering change, but the change will be brought about in an orderly fashion, could have a positive impact on the investment community.

Senator DIXON. As distinguished, as you point out, from abruptly executed tax reform.

Mr. TOBIN. Precisely.

Senator DIXON. Another thing you said that was very interesting to me is this whole question of the accelerated cost recovery system and the investment tax credits. You said that it is hard for you to believe that Treasury wants to remove these incentives, as they have been responsible in part for our improved economy. You really see that, then?

Mr. TOBIN. Yes.

Senator DIXON. And you believe that those—particularly the ACRS and the investment tax credit—have in fact actually excited investment and been a valuable tool?

Mr. TOBIN. I do, indeed. In fact, as it respects the investment tax credit, one could go back to the early Kennedy years of administration and, I think, clearly see a plus impact to the whole economy through the then-introduction of the investment tax credit.

But, yes, you are reading my point exactly.

Senator DIXON. I am particularly interested in all of the things you are saying about the impact of this kind of legislation on the business community. We are tremendously concerned about that.

You know, everybody believes that we ought to have tax simplification, but nobody understands the net effect of all of this, and we don't want to take an economy that is now showing us some vigor and do something to dampen it all of a sudden in a way that all of us would regret at a later date.

I want to tell you that we consider what you have said very, very valuable, and I thank you for accommodating the committee.

Mr. TOBIN. Thank you, Senator Dixon.

Senator DIXON. Mr. Jones, we thank you for being so patient. Please go ahead.

STATEMENT OF E. PATRIC JONES, PRESIDENT, THE URBAN FUND OF ILLINOIS, INC., MANAGING OFFICER, COMBINED OPPORTUNITIES, INC., AND PAST CHAIRMAN, THE AMERICAN ASSOCIATION OF MESBICS

Mr. JONES. Mr. Chairman and members of the committee, I am E. Patric Jones, president of the Urban Fund of Illinois. I am also managing officer of Combined Opportunities, Inc.

In addition, I am past chairman of the American Association of MESBIC's and am currently a member of its board of directors.

Both the Urban Fund and Combined Opportunities are MESBIC's, minority enterprise small business investment companies, which are authorized to invest in minority-owned small businesses. Through our direct investment activity and participation with other financing sources, the Urban Fund and Combined Opportunities have generated some $27 million in total financings for minority businesses. You can see, then, the extent of our involvement in small business.

I am pleased to be able to discuss with you the Treasury Department's proposals for tax reform and how they might impact on small business. We enthusiastically support tax reform. But tax reform must be fair and equitable. Any reform must be based on the realization that small business is one of our country's major resources; that small business is a particularly important partner in the Nation's pursuit of economic and social goals.

You have heard the statistics about job creation before, but I think they are very important. For the period 1981 through 1982, small business generated all of the 984,000 net new jobs created. These small businesses, with fewer than 20 employees each, produced a total of 2,650,000 new jobs, while big business lost 1,664,000. In 1984, the MESBIC industry alone, through its portfolio of small minority businesses, created or maintained 8,470 jobs.

The Treasury's reform proposals, however, perpetuate a bias against small business, in our opinion. These proposals will increase the disproportionate burden small business must bear. In several areas, the results could be disastrous.

First I would like to discuss the capital gains tax rate. The Treasury calls for an end to the capital gains tax differential. Capital gains would be treated as ordinary income.

The impact of this on the supply of capital for entrepreneurs could be devastating. The historical lessons in this area are undeniable. When the capital gains tax differential was eliminated in 1969, venture capital almost dried up. Net new private capital invested in venture capital firms declined from $171 million in 1969 to $10 million in 1975.

For the 8-year period, 1970 through 1977, only $466 million was received by our venture capital industry. When the tax was reduced in 1978, the venture capital industry received $600 million, more than was received in all of the previous 8 years.

Big business grows from small business, and small business needs capital to grow. The venture capital industry supplies much of that growth capital. With the elimination of the capital gains differential, our industry invested $2.9 billion from 1970 through 1977, compared to $11.7 billion during 1978 through 1983, and for 1984 we think that number will exceed $3 billion.

It is quite clear that the elimination of the capital gains differential can have a substantial effect on our economic growth rate. It is simple, really: Small, fast-growing companies have the greatest potential to create new jobs and technological advance. These companies need financing for growth, and in their early stages venture capital is frequently the only capital available to them.

These kinds of investments are risky. Investors require incentives for risk taking. When we increase capital gains tax rates, or eliminate the differential, we think we do all the wrong things: We discourage risk investing, we slow the economy, and we reduce Federal tax revenues.

Not only do we oppose the increase in capital gains tax rates; we urge the complete elimination of the capital gains tax. Japan and West Germany do not tax long-term capital gains, while the United States has the third highest capital gains tax rate in the industrialized world.

Senator DIXON. I would like to interrupt one more time there, Mr. Jones, as I did with the prior witness, simply to say that I note that you are talking about Treasury, but you are aware, are you not, of the fact that the others generally repeal that as well?

Mr. JONES. Yes.

Senator DIXON. So you are, as we indicated here, here because the hearing is on Treasury, but the others—Bradley-Gephardt repeals entirely, as does Treasury. Kemp-Kasten has a kind of convoluted method of dealing with it at a lower percentage. But your remarks would generally apply to whatever is the case on all of them?

Mr. JONES. Yes.

Senator DIXON. Thank you for letting me interrupt.

Mr. JONES. I would like to address relief of double taxation of dividends. For small business, the proposal is not relief at all; it is in fact discrimination. How many rapidly growing companies pay dividends? Very few. The internal need for capital is simply too great.

This proposal will allow mature companies, those that pay dividends, a significant tax advantage. We would in fact urge that the law allow deductibility of dividends paid by corporations to shareholders of small business in order to encourage payment of dividends and to foster investment in small business.

As to special bad-debt deduction for financial institutions, this is a proposal that is very dear to our hearts. Tax relief or incentives allow us to make riskier investments. Without it, our investment policies will probably reflect more risk aversion. The end result is that we will stifle capital investment.

In regard to interest expense, Treasury and the other proposals would make this nondeductible for corporate taxpayers. Fast-growing companies frequently have significant debt burdens; it is simply another form of growth capital.

The deduction of interest expense allows the well-run company to use debt efficiently for its growth. The full taxation of interest expense could significantly retard that growth.

There are others of the proposals that can have a detrimental effect on small business, but for the sake of time, I will not cover them here.

Small business will be the most severely affected if budget deficits are not reduced. We applaud and encourage hard measures to reduce the deficits. We venture capitalists believe that small business can play a constructive role in reducing the deficits by generating jobs, creating technological innovation, and fueling economic growth.

Tax reform, in addition to simplification, should recognize and maintain basic economic incentives for our entrepreneurs, and it should acknowledge the need for an equitable distribution of the tax burden.

I thank you for letting me share these thoughts with you, and I will be happy to answer any questions.

[The prepared statement of Mr. Jones follows:]

STATEMENT OF E. PATRIC JONES, PRESIDENT, THE URBAN FUND OF ILLINOIS, INC.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am E. Patric Jones, President of The Urban Fund of Illinois here in Chicago. I am also the managing officer of Combined Opportunities, Inc. In addition I am a past Chairman of The American Association of MESBICs and am presently a member of its Board of Directors. Until recently, I was also Senior Vice President of Hyde Park Bank and Trust Company.

Both the Urban Fund and Combined Opportunities are MESBICs, minority enterprise small business investment companies, which are authorized under the Small Business Investment Act of 1958, as amended, to invest in minority-owned small businesses. Through our investment activity and participation with other financing sources, we have generated some $27 million in total financings of minority businesses.

You can see, then, the extent of our involvement with small business.

I am pleased to be able to discuss with you the Treasury Department's proposals for tax reform and how they might impact on small business.

We enthusiastically support tax reform. But tax reform must be fair and equitable. Any reform must be based on a realization that small business is one of our country's major resources; that small business is a particularly important partner in the nation's pursuit of economic and social goals.

For the period 1981 and 1982, small business generated all the 984,000 net new jobs created. These small businesses with fewer than 20 employees each, produced a total of 2,650,000 new jobs while big business loss 1,664,000 jobs. In 1984, the MESBIC industry alone, through its portfolio of small minority businesses created or maintained 8,470 jobs.

The Treasury's reform proposals, however, perpetuate a bias against small business. These proposals will increase the disproportionate burden small business must bear. In several areas, the results could be disastrous.

1. CAPITAL GAINS TAX RATE. The Treasury calls for an end to the capital gains tax differential. Capital gains would be treated as ordinary income.

The impact of this on the supply of capital for entrepreneurs could be devastating. The historical lessons are undeniable. When the capital gains tax defferential was eliminated in 1969, venture capital almost dried up. Net new private capital invested in venture capital firms declined from $171 million in 1969 to $10 million in 1975. For the 8 year period, 1970 - 1977, only $466 million was received by our venture capital industry. When the tax was reduced in 1978, the venture capital industry received $600 million, more than was received in the previous eight years.

Big business grows from small business and small business needs capital to grow. The venture capital industry supplies much of that growth capital. With the elimination of the capital gains differential, our industry invested $2.9 billion from 1970 - 1977 compared to $11.7 during 1978 - 1983 For 1984, that number will exceed $3 billion.

It is quite clear that the elimination of the capital gains differential can have a substantial effect on our economic growth rate. It's simple, really: small fast growing companies have the greatest potential to create new jobs and technological advance. These companies need financing for growth and in their early stages, venture capital is the only capital available to them. These kinds of investments are risky. Investors require incentives for risk-taking.

When we increase capital gains tax rates, we do all the wrong things:

a. discourage risk investing
b. slow the economy
c. reduce federal tax revenues

Not only do we oppose the increase in capital gains tax rates, we urge the complete elimination of the capital gains tax. Japan and West Germany do not tax long-term capital gains while the United States has the third highest capital gains tax rate in the industrialized world.

2. RELIEF FOR DOUBLE TAXATION OF DIVIDENDS. For small business, the proposal is not "relief" at all. It is in fact, discrimination. How many rapidly growing companies pay dividends? Very few! The internal need for capital is too great. This proposal will allow mature companies, those that pay dividends, a significant tax advantage.

We would, in fact, urge that the law allow deductibility of dividends paid by corporations to shareholders of small business in order to encourage payment of dividends and to foster investment in small business.

3. SPECIAL BAD DEBT DEDUCTION FOR FINANCIAL INSTITUTIONS. Tax relief (or incentives) allow us to make riskier investments. Without it, our investment policies will reflect more risk aversion. The end result is that we stifle capital investment.

4. INTEREST EXPENSE. Treasury would make this nondeductible for corporate tax payers. Fast growing companies frequently have significant debt burdens.

It's simply another form of growth capital. The deduction of interest expense allows the well-run company to use debt efficiently for its growth. The full taxation of interest expense could significantly retard that growth.

There are others of the proposals, Mr. Chairman, that can have a detrimental effect on small business, but I won't cover them here.

Small business will be the most severely affected if budget deficits are not reduced. We applaud and encourage hard measures to reduce the deficits. We venture capitalists believe that small business can play a constructive role in reducing the deficits by generating jobs, creating technological innovation and fueling economic growth.

Tax reform, in addition to simplification, should recognize and maintain basic economic incentives for our entrepreneurs and it should acknowledge the need for an equitable distribution of the tax burden.

Thank you and I'll be happy to answer any questions.

Senator DIXON. Well, I appreciate that very much.

Again, my general impression of what you were saying here, Mr. Jones, is this: Proceed with infinite caution; everybody is for tax reform; but many people in the business community recognize that if we do something too precipitously here, it can have very damaging fallout in the business community.

Mr. JONES. Yes, sir, that is correct. I think I am saying one other thing, and that other thing is that in developing tax reform, I think there has to be a recognition of and an orientation toward small business; that any tax reform has got to take into account that small business is a terribly important factor in our American economy. This economy is based on incentive, and we have got to provide incentive for investment for small business.

Senator DIXON. You feel very strongly about the capital gains tax rate; you have made that very clear here.

Mr. JONES. I couldn't feel stronger.

Senator DIXON. And I get the sense that you don't think the question of double taxation is much of a question at all from the standpoint of small businesses. Is that a fair interpretation?

Mr. JONES. That is correct. I suppose, if I worked for General Motors, I might think differently. But small businesses rarely pay dividends. They have the need for capital.

Senator DIXON. Sure. Now, the interest expense business is an interesting one because that is a big item that everybody is skating around here, and your feeling is that it is a very important deduction from the standpoint of the small business community.

Mr. JONES. I do; it is a legitimate cost of doing business. For the small business that has a need of capital, they can get that capital in one of two ways: either through selling equity or by borrowing it. To tax interest expense would have a serious effect on the profitability of many small businesses.

Senator DIXON. Now, I think you are telling us that you feel there ought to be a different treatment for small businesses in the tax bill. Is that a fair interpretation of what you have said here?

Mr. JONES. I would like to be very careful about the words that I use.

Senator DIXON. Well, I don't want to offend, but I got that impression.

Mr. JONES. Yes, that is correct. I think there has got to be a special recognition that small business has very different needs from mature businesses.

Senator DIXON. And I think another thing that is very important to us is that we are seeing a greater amount of involvement in minority businesses than we used to see, of recent origin, and I think we want to see that continue. We want to see those opportunities expanded.

Do you believe that the tax proposals being discussed today would have a negative impact upon the entrepreneurial upswing among minority businesses, in your opinion?

Mr. JONES. I think it would have a very negative effect upon the growth and future development of minority business.

Senator DIXON. Mr. Stockman appeared before the Small Business Committee last week and indicated that there is a surplus, all kinds of venture capital out there for small business opportunities, and that there is no need for guaranteed SBA loans. From your perspective, what do you think about that?

Mr. JONES. Well, I don't know where Mr. Stockman gets his data. There are certainly venture capital companies which are continuing to replenish their pools of funds for investment. Just last year, certain of our venture capital companies ran out of funds. So there is a continuing need for that.

I think many small businesses have been able to get conventional bank financing, and grow, and develop because of the SBA-guaranteed loans. Without that surety, that guarantee to the lending institutions, those businesses would not have been able to get the money.

I think there is a need for SBA-guaranteed loans. I think the SBA has served a very noble and worthwhile role in the growth of this economy.

Senator DIXON. I think that most of us agree that we are going to see the end of direct loans pretty shortly. Do you have any trouble with that?

Mr. JONES. I think we would prefer not to see it, but one learns to accept certain changes.

Senator DIXON. Do I sense that you are saying that if the Treasury tax—I don't want to put words in your mouth, but I get the impression you are saying that if the Treasury tax proposal were implemented and the Small Business Administration were eliminated, that it would have a very, very detrimental impact upon small businesses, particularly the kind that you have been involved in over the years.

Mr. JONES. That is exactly what I am saying, yes.

Senator DIXON. I thank you for giving us the valuable contribution of your statement.

The next panel would be Mr. Gerald Kolb, the treasurer of United American Food Processors, accompanied by Jacob Brandzel of Laventhol & Horwath; and Sheila Smith, the vice president of Granite Technologies, Inc., Glow Lite Corp., and FMS, Inc.

Good morning. Do we have enough microphones for everybody? Do you want to join us at the table there? They even gave Mr. Brandzel a nice card to identify him. Very good.

Would you proceed, Mr. Kolb, if Ms. Smith will permit that order?

Ms. SMITH. No problem, Senator.

STATEMENT OF GERALD M. KOLB, TREASURER, UNITED AMERICAN FOOD PROCESSORS, ACCOMPANIED BY JACOB BRANDZEL, LAVENTHOL & HORWATH

Mr. KOLB. Good morning.

Senator DIXON. Good morning.

Mr. KOLB. My name is Gerald Kolb, and I am the treasurer of United American Food Processors of Chicago, IL.

My company would definitely fall under the classification of small business. We are engaged in the processing and sale of meat products to the hotel and restaurant industry. Currently, we employ between 90 and 110 workers, and our annual sales volume is between $25 and $30 million. The trend, however, in recent years has been downward both in sales and profits.

One of the major factors affecting our business involves tax costs, primarily at the Federal level, and the administrative burden placed upon us in recordkeeping which takes away from time we can devote to the proper management of the company. As a small business, we find that we continually have to become acquainted with new and changing regulations and are frequently forced to adjust our recordkeeping systems.

We generally favor tax simplifications and reforms. However, we want to note that over the last 10 years, we have been faced with a new reform and simplification act in almost all of the 10 years. Effectively, we find it difficult to plan. Any planning with respect to equipment acquisitions, marketing, and long-range sales strategies becomes hampered by frequent legislative rulings and court cases which seek to interpret the morass of legislation.

The current proposals with respect to ACRS will be replaced with seven new classes of assets, and these are going to be indexed in each of the following years. We just do not know how we would accomplish the recordkeeping in such a system.

Then we often find that we become the scapegoats in that, after having planned our strategies based upon these long-standing tax provisions, these are being pulled out from under us—such as the Treasury proposals—and the reason given is for the simplification or closing of loopholes.

Let me now turn specifically to a number of the Treasury proposals which would have, in my opinion, a significant negative impact on small business.

First, there would be a real increase in corporate tax cost to small business for the following reasons: The current surtax levels which have provided a 25.75 percent effective tax on the first $100,000 of taxable income would be eliminated. A flat rate of 33 percent is proposed for all taxable income.

Many small businesses are lucky to have $100,000 of taxable income and will now find that they are paying an increased tax cost at 33 percent. Small businesses above $100,000 are obviously going to have an additional tax burden of $7,250. Larger corporations can bear the brunt of this increased cost much easier than small businesses.

Additionally, the Treasury proposals would effectually increase tax costs by removing incentive for capital acquisitions, eliminating investment tax credit and ACRS.

Specifically, in my industry, equipment in the food processing industry must be USDA approved. This generally means that it must be made of stainless steel and have completely enclosed mechanisms and that it must have undergone the rigorous inspection of the USDA.

These factors cause the costs of such equipment to be far in excess of general manufacturing equipment, and, consequently, to eliminate the tax incentive afforded to the purchasers of such equipment greatly reduces the efficiency of conducting our business in its most modern form.

Additionally, I believe you would have the consequence of diminishing the sales and employment of the various firms engaged in the manufacture of this equipment.

The Treasury proposals provide for new cost recovery rules that would account for inflation and supposed real economic loss inherent in the use of assets over time. Although this sounds appropriate, it would significantly increase our recordkeeping requirements, since it provides for assignment to one of seven classes, which assignment requires subtle interpretations, and then each class would be assigned an invariant depreciation rate, ranging from 32 percent to 3 percent. The depreciation rate would be applied to an index basis of an asset.

Complexity, complexity, complexity! I love tax simplification. [Laughter.]

Senator DIXON. If I may interrupt at that point, you are saying to us there that at least insofar as the ACRS question is concerned, it is a complication, not a simplification. Is that not true?

Mr. KOLB. That is correct; that is exactly my feeling.

Senator DIXON. And that would apply, if I may interrupt again, as I have with others, to all the plans, not just Treasury.

Mr. KOLB. I agree with you.

Senator DIXON. Pardon me for interrupting.

Mr. KOLB. I also believe that it is likely that most equipment has real economic loss at a rate greater than what is currently allowed, and if that is the case, several years later, we will be accused of utilizing these rules to our benefit as another so-called loophole.

I would propose that if Congress seeks to limit the benefits of ACRS and ITC that they place dollar ceilings on the amount of qualified property which would enjoy these benefits. This, in part, could provide incentives to small businesses.

Although the present administration is adamant in its desire not to increase taxes, the tax burden to small business continuously increases in a very subtle manner through increased payroll tax costs. In the last 25 years, the cost to a company for each individual earning the maximum taxable wage for Social Security purposes has increased by approximately 2,000 percent to a current level of $2,792, based upon a salary level of $39,600.

With the current questionable status of Social Security, it is evident that both the base of taxable salary and Social Security rate will increase. Since each employer matches the amount paid by the employee, as both the base and rates go up, we pay additional taxes. This does not even take into consideration the amount we pay for Federal unemployment taxes, which also represents a significant cost.

To further complicate this program, the Internal Revenue Service is constantly expanding the base of taxable wages to bring more and more items under the payroll tax umbrella; for example, third-party-paid benefits and the value of the personal use of business property.

The Treasury has proposed severe limitations on the deductibility of business meals and entertainment expenses. This will result in a very significant competitive disadvantage to small businesses when compared to large companies who are willing to spend the dollars to entertain clients, irrespective of whether they get the benefit of a tax deduction.

Most small enterprises conduct their business at a personal level as opposed to relying on name recognition built up through large advertising expenditures. In our industry, it is not uncommon to do sales research by eating in various restaurants. We are able to determine the quality and cut of the meat products being used and are therefore able to quote competitive prices. Typically, this type of expense is characterized as entertainment, although it is really much more market-research oriented.

I might point out that the ripple effect of the proposed cuts in the entertainment allowances by businessmen would affect many of our customers, which in turn would ripple to our industry. We saw this happen several years ago when the three-martini lunch was a popular topic of conversation.

Most of the demand for entertainment comes from the client and therefore becomes a necessary expenditure, whether or not we receive a tax deduction.

I would like to make one brief comment as to travel expense. Again, a small business is generally located in one particular geographic area but finds it necessary to travel in order to service clients. This should be compared with a particular office of a large multioffice company which is required to cover a smaller geographic area of the United States and may not have the same burdensome travel and entertainment requirements. Again, the small business is being penalized if these deductions are limited.

I previously commented upon an increased administrative burden necessitated by the Treasury proposals for indexing assets and expanding the category of assets which would require additional recordkeeping. These recordkeeping requirements will be on top of existing burdensome recordkeeping requirements such as those required by OSHA, EEO, Bureau of the Census, USDA, Stockyards and Packers Administration, and the Internal Revenue Service.

I find most of the proposals suggested by Treasury either would have a negative impact on small business or would only benefit larger corporations; for example, the dividend paid deduction would only benefit those companies who are in a position to pay dividends. Most small companies find it necessary to plow back their earnings, if there are any, to meet their capital asset acquisition and working capital needs.

I wish to thank the committee for allowing me to present my views and would be glad to answer any questions you may have.

[The prepared statement of Mr. Kolb follows:]

GERALD M. KOLB
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FOR SENATE ON SMALL BUSINESS COMMITTEE

TESTIMONY--MARCH 4, 1985

My name is Gerald Kolb and I am treasurer of United American Food Processors, Chicago, Illinois. My company would definitely fall under the classification of small business. We are engaged in the processing and sale of meat products to the hotel and restaurant industry. Currently we employ between 90 and 110 workers and our annual sales volume is between 25 and 30 million dollars. The trend, however, in recent years has been downward both in sales and profits. One of the major factors affecting our business involves tax costs, primarily at the federal level, and the administrative burden placed upon us in recordkeeping which takes away from time we can devote to the proper management of the company. As a small business we find that we continually have to become acquainted with new and changing regulations and are frequently forced to adjust our recordkeeping systems.

Any effective planning with respect to equipment acquisitions, marketing, and long range sales strategies become hampered by frequent legislative rulings and court cases which seek to interpret the morass of legislation.

We often find that we become the scape goats in that after having planned our strategies based upon long standing existing tax provisions, these are being pulled out from under us (such as the Treasury proposals) and the reason given for this is the closing of loop holes.

Let me now turn specifically to a number of the treasury proposals which would have, in my opinion, a significant negative impact on small business.

First, there would be a real increase in corporate tax cost to small business for the following reasons: the current surtax levels which have provided a 25.75% effective tax on the first $100,000 of taxable income would be eliminated. A flat rate of 33% is proposed for all taxable income. Many small businesses are lucky to have $100,000 of taxable income and will now find that they are paying an increased tax cost at 33 percent. Small businesses above $100,000 are obviously going to have an additional tax burden of $7,250. Larger corporations can bear the brunt of this increased cost much easier than small businesses.

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Specifically, equipment in the food processing industry must be USDA approved. This generally means that it must be made of stainless steel, have completely enclosed mechanisms and to have undergone the rigorous inspection of USDA. These factors cause the costs of such equipment to be far in excess of general manufacturing equipment and consequently, to eliminate the tax incentive afforded to the purchsers of such equipment, greatly reduces the efficiency of conducting our business in its most modern form. Additionally, I believe you would have the consequence of diminishing the sales and employment of the various firms engaged in the manufacture of this equipment.

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I also believe that it is likely that most equipment has real economic loss at a rate greater than what is currently allowed and if that is the case, several years later we will be accused of utilizing these rules to our benefit as another so called loop hole.

I would propose that if Congress seeks to limit the benefits from ACRS and ITC that they place dollar ceilings on the amount of qualified property which would enjoy these benefits. This, in part, could provide incentives to small business.

Although the present administration is adament in its desire not to increase taxes, the tax burden to small business continously increases in a very subtle manner through increased payroll tax costs. In the last 25 years the cost to a company for each individual earning the maximum taxable wage for Social Security purposes has increased by approximately 2000% to a current level of $2,792 based upon a salary level of $39,600. With the current questionable status of Social Security it is evident that both the base of taxable salary and Social Security rate will increase. Since each employer matches the amount paid by the employee, as both the base and rates go up, we pay additional taxes. This does not even take into consideration the amount we pay for federal unemployment taxes which also represents a significant cost. To further complicate this problem, the Internal Revenue Service is constantly expanding the base of taxable wages to bring more and more items under the payroll tax umbrella; for example, third-party paid benefits and the value of the personal use of business property.

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Most of the demand for entertainment comes from the client and therefore becomes a necessary expenditure whether or not we receive a tax deduction. I would like to make one brief comment as to travel expense. Again a small business is generally located in one particular geographic area but finds it necessary to travel in order to service clients. This should be compared with a particular office of a large multi-office company who is required to cover a smaller geographic portion of the United States and may not have the same burdensome travel and entertainment requirements. Again, the small business is being penalized if these deductions are limited.

I previously commented upon an increased administrative burden necessitated by the Treasury proposals for indexing assets and expanding the category of assets which would require additional recordingkeeping. These recordkeeping requirements will be on top of existing burdensom recordkeeping requirements such as those required by OSHA, EEO, Bureau of the Census, USDA, Stockyards and Packers Administration and the Internal Revenue Service.

I find most of the proposals suggested by Treasury either would have a negative impact on small business or would only benefit larger corporations, for example, the dividend paid deduction would only benefit those companies who are in a position to pay dividends. Most small companies find it necessary to plow back their earnings, if there are any, to meet their capital asset acquisition and working capital needs.

I wish to thank the Committee for allowing me to present my views and would be glad to answer any questions you may have.

Senator Dixon. Would you excuse me just a minute, Mr. Kolb? Can you bear with us a moment?

Mr. Kolb. Sure.

Senator Dixon. You were talking at pretty great length there, Mr. Kolb, about these entertainment expenses. I don't know what the other suggested plans do—perhaps we ought to get that on the record—but it would indicate here that Treasury says, for each person participating in each business meal, this deduction would be limited to $10 for breakfast, $15 for lunch, and $25 for dinner. The meal cost limitations would include gratuities and tax with respect to the meal, so that there is some allowance.

Would your point be that it is not adequate? Is that what you are suggesting here? I am pretty sure that in most places in the big cities, dinner with a couple of drinks probably is going to go over $25. Is that the point you are trying to make? For that matter, lunch will go over $15, I expect. It surely would in Washington.

Mr. Kolb. I agree with your statement about the high cost of meals out. However, what I was referring to is that the small businessman, when entertaining a client, spends what he has to spend, and if there is any limitation placed, he is not going to be able to adhere to it, so he is really going to bear the higher tax burden resulting from it.

Senator Dixon. Your point would be that as long as it is reasonably documented, you ought to be allowed to do it without these dollar limitations?

Mr. Kolb. And there is a valid business purpose for it.

Senator Dixon. Generally speaking, though, what you are suggesting here once again is that tax simplification is a wonderful thing, but there are a good many things about this program that cause you some concerns as a businessman?

Mr. Kolb. Yes. All the tax simplification programs we have had in recent years have been a wonderful thing. [Laughter.]

Senator Dixon. I will tell the folks in the Congress you said that.

Mr. Kolb. We have experienced ERISA, TSRA, TEFRA, ERDA, the Technical Adjustment Act, and the Deficit Reduction Act, in recent years.

Senator Dixon. Now we will have a statement by Sheila Smith, the vice president and chairman of the board of Granite Technologies.

You may be excused if you would care to, but if you would like to stay, we will go into this matter a little further. It is up to you.

Yes, Ms. Smith.

STATEMENT OF SHEILA SMITH, VICE PRESIDENT AND CHAIRMAN OF THE BOARD, GRANITE TECHNOLOGIES, INC., AND VICE PRESIDENT AND TREASURER, GLOW LITE CORP.

Ms. Smith. Thank you very much for asking me to appear as a witness before you today to speak on behalf of smaller businesses about the impact that the so-called tax reform and simplification proposal recently released by the Treasury Department will have on our businesses.

I hesitate to assume that I can speak for all smaller firms, since we are many and varied, so I shall speak from my own experience and concerns and hope that they have something in common with those of other small business owners. I think they do.

First, I would like to tell you a bit about my own experience in directing businesses. My professional training is in the field of investment banking, structuring mergers and acquisitions. I was affiliated for 8 years with the firms of Lehman Bros., duPont Walston, Mesirow, and Aries, Ltd. In 1979, I began my own financial consulting practice.

Four years ago, I worked on an acquisition plan intended to bail out the Glow Lite Corp., located in Pauls Valley, OK. Glow Lite manufactures indicator lamps and circuit components.

At the time of our purchase, Glow Lite had a number of problems to solve, including quality control and combating extensive foreign competition. To survive meant sacrifices on everyone's part. Some employees were laid off; others deferred wage increases for 2 years. The investors took the personal tax credits accorded them through the investment tax credit and accelerated cost recovery system and reinvested them in Glow Lite to provide the company with much-needed working capital. Without this reinvestment, the company would have been bankrupt.

Our faith in the opportunity presented by Glow Lite has been sustained. Today our product is synonymous with quality. Companies such as General Electric put our products into production with quality control tests. That has saved them money.

Our management team is investigating joint ventures with China and India, and today we continue to be the second largest employer in Pauls Valley, OK.

Two years ago, I was approached by a Swiss holding company with operations in France, Italy, Portugal, and the Middle East. The company proposed to establish a new location for their marble and granite processing business in the United States.

Starting from scratch, I structured the financing, determined the location, and recruited the staff that has brought into being Granite and Marble World Trade, a division of Granite Technologies, Inc. We are a new Chicago business, located in a neighborhood where we are creating 120 new jobs.

My experience as a small business director has been in turning troubled businesses around and developing new income streams. Thus, I would like to approach the Treasury's tax reform and simplification proposal as I would approach deciding what to change in a troubled business, since I think the problems that I face in my businesses have a lot in common with the problems faced by the Treasury.

Looking at the changes proposed, what does the Treasury really want to achieve? If one reads the proposal, one finds in the first paragraph that the stated goals are to be "neutral, simple, equitable, and inflation-proof." That is nice language, but let's be honest. How can any tax plan be neutral? And how can a tax plan that introduces all of the indexing described in this proposal be simple?

Equitable? One look at the flat tax makes it clear that it will not be equitable, particularly for small businesses, whose taxes will go up significantly. The smaller the business, the higher the effective tax rate will be. No, the flat tax only benefits larger businesses. It is not equitable.

And all the concern that capital-intensive industries must forfeit their perceived current advantages over labor-intensive and inventory-stocking industries is misinformed. Someone has failed to note that capital-intensive industries have to put much more money back into their industries to stay in business. So, under the flat tax, the company that is not capital-intensive that makes, say, $1.5 million in 1 year and is taxed 33 percent comes out far better than the capital-intensive company that makes $1.5 million, is taxed 33 percent, but has to reinvest significantly in the business.

Finally, I would like to discuss "inflation-proof." What does that mean? Currently, we have minimal inflation. It looks like many of these changes are proposed to correct things that happened 5 years ago. If inflation should recur, there are ways to take it into effect without restructuring the whole system.

The Treasury's language sounds good politically, especially to the middle American who says, "Oh, boy, now they're going to raise corporate taxes and lower mine." In truth, the repercussion in the economy of increasing the tax burden on smaller and mid-sized firms, those very firms that have been charged with the responsibility—and take it quite seriously—to create jobs could be to cost those same middle Americans their jobs, and the Treasury, the tax base represented by their income.

Let me return to my original question. What does the Treasury really want to achieve through these changes? What does it really need? It looks to me like it needs some short-term income. I would like them to show me how this proposal will provide it.

Let me now turn and address the individual provisions that are the stated focus of our meeting here today. They are: the investment tax credit, or ITC, which the Treasury proposes to repeal; the depreciation system, which the Treasury proposed to slow down by replacing the accelerated cost recovery system, known as ACRS; direct expensing of equipment costs, which the Treasury proposes to freeze at $5,000 per year; and the long-term capital gains tax exclusion, which the Treasury proposes to eliminate.

As someone intimately involved in a capital-intensive industry—granite and marble processing—I would like to say that the investment tax credits and accelerated depreciation schedules are nice and a bonus that is sometimes an incentive. But decisions for a company to buy a piece of equipment costing $200,000 are never really made because one can get a 5-year writeoff and a $20,000 tax credit. Such purchases are made because of need and the benefits they will bring to the firm.

Take accelerated depreciation. Whether a piece of granite-cutting equipment is written off over 5 or 10 years does not change the fact that if it outlives its depreciation timespan and is still producing, we will eventually pay taxes generated by it, and if we sell it, we will also pay taxes. In short, what you are doing is not really reforming anything but juggling, by a few years, a set of timeframes.

Let me reiterate what Mr. Kolb mentioned, and Mr. Tobin, that these benefits, the ITC and the accelerated depreciation, are used quite often by investors in helping small businesses that don't have the capital in their businesses to go out and buy that much-needed equipment.

To read the proposal is to suspect that the real motive behind changing the ITC and ACRS is to get General Electric to pay taxes. Admittedly, any tax structure in which GE, with huge revenues, is not paying taxes—and is in fact getting huge refunds—has something wrong with it. Perhaps that should be dealt with on an individual basis.

Yet why should it precipitate the change of a system which is, for our capital-intensive-dominant region and smaller businesses, working to revitalize industry? Why should we change a system which allows small business owners to take depreciation dollars and reinvest those dollars in the continued expansion of their businesses?

Let me speak to the freezing of the direct expensing benefit at $5,000. That is a small consideration. For a firm that must invest in the types of depreciable assets covered by direct expensing, the opportunity to write them off quickly, without recordkeeping, is a bonus, and it sometimes is an incentive. But, $5,000 or even $10,000, the amount is so small that freezing it at $5,000 will seem a hardship only to the very smallest firms.

On the other hand, eliminating the long-term capital gains tax exclusion will undoubtedly have an impact on risk taking in a number of markets, particularly in new, fast-growing, or ailing industries that are high risk and require significant capital. Another market that will be affected is real estate.

When my husband and I decided to assume ownership of Glow Lite Corp., we put fixed assets into a tax shelter to raise the equity to put into the holding company that bought Glow Lite. Yes, capital gains treatment was an additional incentive to assume the risks, although our belief in the opportunity and conviction that it could be made to go was our prime incentive. And we had to put all tax gains back into the company to keep it going and to foster its revitalization.

In the end, our tax advantages were used to increase the local tax base. Yes, our asset might be worth more, and our tax advantage also promoted that. But if we sell it for more than we paid for it, the Treasury will recoup the tax benefits it allowed us originally.

While they are rarely the main reason for making a business decision, capital gains incentives promote the taking of business risks. If one must reward an individual to do that, and it allows a business to start, creating jobs, what is wrong with that? The reform that is needed is to assure that they are always utilized to promote continued growth.

In short, I have mixed feelings about the Treasury's proposal to simplify the tax structure. Indeed, I fully believe it needs both simplification and reform. Yet I don't really see how this proposal simplifies, reforms, or in any significant way works toward realizing what the Treasury really needs—short-term income and long-term improvement of the economy.

Instead, much of the proposal appears to be a juggling of timeframes and minuscule amounts, except in the area of the flat tax, where small businesses are expected to kick in more so that big business can kick in less in the name of equality.

But the real bottom line of the Treasury's proposal, and one that has already been felt by small business, even though the changes have not yet been enacted, is to pull the rug out from under all business planning decisions. One cannot plan and enact strategies for growth in a volatile economy where you cannot count on how you are going to be taxed. This proposal has already precipitated a stressful and stagnant situation.

For small business, this proposal for tax structure change—the third such set of changes we may have to accommodate in less than 5 years—presents another accounting nightmare. Every change in the tax statutes affecting business, whether big or small, requires us to purchase additional professional services, alter systems, retrain staff—the costs go on and on.

And what will we get from these changes? What will the Treasury get? What will the benefits to the country be? Have we worked with the last two sets of reforms long enough to see what their benefits are and whether changes like these are really needed? I as a businessperson do not initiate change for the sake of change. I initiate change to achieve results.

I think it is obvious that the country's real problem is a deficit of major proportions. Its potential impact on our future and that of our children is currently masked by the fact that we are funding this deficit with investment from overseas. This cannot continue forever.

Any changes that are proposed should directly address the deficit. If we do not address this primary problem soon, with achievable results clearly in mind, before the overseas money solution ends—and it inevitably will—our economy, political situation, and society at large will experience instability such as we have never seen.

How can the Treasury deal with negative cash-flow? The obvious solution to any businessperson is to increase revenue at the same time you reduce costs. Everyone who has been faced with this problem, as nearly everyone has in the past few years, knows it is easier to reduce expenditures than to create revenue.

The Treasury's proposal takes a stab at increasing revenue, although not the quick, short-term revenue it needs. It does not appear to be balanced with a consistent program of reducing costs.

Thus I find it impossible to support the Treasury's current tax reform proposal because I see no real evidence or thoughtfulness on what the desired results from the proposed changes might be.

[The prepared statement of Ms. Smith follows:]

STATEMENT BY SHEILA SMITH

Vice President and Chairman of the Board
Granite Technologies, Inc.
2434 W. Fulton St.
Chicago, IL
and
Vice President and Treasurer
Glow Lite Corporation
Pauls Valley, OK

PRESENTED BEFORE
THE U.S. SENATE COMMITTEE ON SMALL BUSINESS
March 4, 1985
Chicago, IL

Thank you very much for asking me to appear as a witness before you today to speak on behalf of smaller businesses about the impact that the "so-called" tax reform and simplification proposal recently released by the Treasury Department will have on our businesses.

I hesitate to assume that I can speak for all smaller firms--since we are so many and so varied--so I shall speak from my own experience and concerns and hope that they have something in common with those of other small business owners. I think they do.

First I would like to tell you a bit about my own experience in directing businesses. My professional training is in the field of investment banking, structuring mergers and acquisitions. I was affiliated for eight years with the firms of Lehman Brothers, duPont Walston, Mesirow, and Aries, Ltd. Then in 1979 I began my own financial consulting practice.

Four years ago, I worked on an acquisition plan intended to bail out the Glow Lite Corporation, located in Pauls Valley, Oklahoma, which manufactures indicator lamps and circuit components. When, at the last minute, the buyer backed out, someone challenged me to complete the deal myself, which after careful consideration, my husband and I did.

At the time of our purchase, Glow Lite had quality problems with their manufacturing process. The company was impacted by imports from Taiwan and Korea, and due to the dollar's strength, precluded from exporting which normally represented 20 percent of sales.

To help us solve our problems, we developed a management team drawn from the rank and file on the company's floor. Together, we developed a plan which included improving the quality of the product, reducing the manufacturing costs, developing additional product applications and licensing some of our manufacturing overseas.

To survive meant sacrifices on everyone's parts. Some employees were laid off; others deferred wage increases for two years. The investors took the personal tax credits accorded them through the Investment Tax Credit and Accelerated Cost Recovery System and reinvested them in Glow Lite to provide the company with much-needed working capital. Without this reinvestment, the company would have been bankrupt.

Our faith in the opportunity presented by Glow Lite has been sustained. Today our product is synonymous with quality. Companies such as General Electric put it into production without quality control tests, which saved them money. Our management team is investigating joint ventures with China and India. And we continue to be the second largest employer in Pauls Valley. I am proud to be Vice President and Treasurer of the firm.

Then, two years ago, I was approached by a Swiss holding company with operations in France, Italy, Portugal and the Middle East. The company proposed to establish a new location for their marble and granite processing business in the United States. Starting from scratch, I structured the financing, determined the location and recruited the staff that has brought into being

Granite and Marble World Trade, a division of Granite Techologies, Inc. We are a new Chicago business located at 2434 W. Fulton in a neighborhood where we have created 120 new jobs. I am Vice President and Chairman of the Board of Granite Technologies, Inc.

You might say that my experience as a small business director has been in turning troubled businesses around and developing new income streams. Thus I would like to approach the Treasury's tax reform and simplification proposal as I would approach deciding what to change in a troubled business, since I think the problems that I face in my businesses have a lot in common with the problems faced by the Treasury.

Looking at the changes proposed--what does the Treasury really want to achieve through these? If one reads the proposal, one finds in the first paragraph that the stated goals are to be "neutral, simple, equitable and inflation-proof." That's all well and good language, but--let's be honest--how can any tax plan be "neutral?" And how can a tax plan that introduces all of the "indexing" described in the proposal be simple?

"Equitable?" One look at the flat tax makes it clear that it will not be equitable--particularly for small businesses, whose taxes will go up significantly--the smaller the business, the higher the effective tax rate will be. And all the concern that capital-intensive industries must forfeit their perceived current advantages over labor-intensive and inventory-stocking industries is misinformed. Someone has failed to note that capital-intensive industries have to put much more money back into their industries to stay in business. So, under the flat tax, the company that is not capital-intensive that makes, say $1.5 million in a year and is taxed 33% comes out far better than the capital-intensive company that makes $1.5, is taxed 33%, but has to reinvest significantly in the business. No, the flat tax only benefits large businesses. It is not equitable.

Finally inflation-proof. What does that mean? Currently we have minimal inflation. It looks like many of these changes are proposed to correct things that happened five years ago. If inflation should reoccur, there are ways to take it into effect without restructuring the whole system.

Thus the Treasury's language sounds good politically--especially to the Middle American who says "Oh boy, they're going to raise corporate taxes and lower mine." In truth, the repercussion in the economy of increasing the tax burden on smaller and mid-sized firms--those very firms that have been charged with the responsibility, and taking it quite seriously, to create jobs--the repercussion could be to cost those same Middle Americans their jobs, and the Treasury, the tax base represented by their income.

So let me return to my original question. What does the Treasury really want to achieve through these changes? What does it really need? It looks to me like it needs short-term income. I would like them to show me how this proposal will provide it.

Let me now turn to address the individual provisions that are the stated focus of our meeting here today. They are:

.The investment tax credit, or ITC, which the Treasury proposes to repeal.

.The depreciation system, which the Treasury proposed to slow down by replacing the accelerated cost recovery system, known as ACRS.

.Direct expensing of equipment costs, which the Treasury proposes to freeze at $5,000 per year.

.The long-term capital gains tax exclusion, which the Treasury proposes to eliminate.

As someone intimately involved in a capital-intensive industry--granite and marble processing--I would like to say that the investment tax credits and accelerated depreciation schedules are nice, a bonus that is sometimes an incentive. But decisions to buy a piece of equipment costing $200,000, for example, are never really made because one can get a five-year write off and a $20,000 tax credit. Such purchases are made because of need and the benefits they will bring the firm.

Take accelerated depreciation. Whether a piece of granite cutting equipment is written off over five or ten years does not change the fact that, if it outlives its depreciation time span and is still producing, we will eventually pay taxes generated by it. And if we sell it, we will also pay taxes. In short, what you are doing is not really reforming anything, but juggling, by a few years, a set of time frames.

Oddly, to read the proposal is to suspect that the real motive behind changing the ITC and ACRS is to get GE to pay taxes. Admittedly any tax structure in which GE, with huge revenues, is not paying taxes--is in fact getting huge refunds--has something wrong with it. Perhaps that should be dealt with on an individual basis. Why should it precipitate the change of a system which is, for our capital-intensive-dominant region and smaller businesses, working to revitalize industry? Why should we change a system which allows small business owners to take depreciation dollars and reinvest those dollars in the continued expansion of their businesses?

Moving on. The freezing of the direct expensing benefit at $5,000 is another small consideration. Again, for a firm that must invest in the types of depreciable assets covered by direct expensing, the opportunity to write them off quickly, without recordkeeping, is a bonus and sometimes an incentive. But $5,000? Or even $10,000? The amount is so small that freezing it at $5,000 will seem a hardship only to the very smallest firms.

On the other hand, eliminating the long-term capital gains tax exclusion will, undoubtedly, have an impact on risk-taking in a number of markets--particularly in new, fast growing or ailing industries that are high-risk and require significant capital. Another market that will be affected is real estate.

I don't have first-hand knowledge about how much the current capital gains treatment serves as an incentive for investors--say, a venture capital group--to put themselves in high-risk situations, gambling on taking their gains out five years from now at preferential tax rates. But I would guess, from my own experience, that it is a factor taken into consideration.

When my husband and I decided to assume ownership of Glow Lite Corp., we put fixed assets into a tax shelter to raise the equity to put into the holding company that bought Glow Lite. Yes, capital gains treatment was an additional incentive to assume the risks, although our belief in the opportunity and conviction that it could be made to go was our prime incentive. And we had to put all tax gains back into the company to keep it going and to foster its revitalization. In the end, our tax advantages were used to increase the local tax base. Yes, our asset is now worth more and our tax advantage also promoted that. But if we sell it for more than we paid for it, the Treasury will recoup the tax benefits it allowed us originally.

While they are rarely the main reason for making a business decision, capital gains incentives promote the taking of business risks. If one must reward an individual to do that, and it allows a business to start, creating jobs, what is wrong with that? The reform that is needed is to assure that they are always utilized to promote continued growth.

In short, I have mixed feelings about the Treasury's proposal to "simplify" the tax structure. Indeed, I fully believe it needs both simplification and reform. Yet I don't really see how this proposal simplifies, reforms, or in any significant way works towards realizing what the Treasury really needs--short-term income and long-term improvement of the economy.

Instead, much of the proposal appears to be a juggling of time frames and miniscule amounts--except in the area of the flat tax, where small businesses are expected to kick in more, so that big business can kick in less in the name of "equality."

But the real bottom line of the Treasury's proposal--and one that has already been felt by small business, even though the changes have not yet been enacted--is to pull the rug out from under all business planning decisions. One cannot plan and enact strategies for growth in a volatile economy where you cannot count on how you are going to be taxed. This proposal has already precipitated a stressful--and stagnant--situation.

And for small business this proposal for tax structure change--the third such set of changes we may have to accomodate in less than five years--presents another accounting nightmare. Every change in the tax statutes affecting business, whether big or small, requires us to purchase additional professional services, alter systems, retrain staff...the costs go on and on. And what will we get from these changes? What will the Treasury get? What will the benefits to the country be? Have we worked with the last two sets of reforms long enough to see what their benefits are and whether changes like these are really needed?

I as a businessperson do not initiate change for the sake of change. I initiate change to achieve results.

I think it is obvious that the country's real problem is a deficit of major proportions. Its potential impact on our future and that of our children is currently masked by the fact that we are funding this deficit with investment from overseas. This cannot continue forever. Any changes that are proposed should directly address the deficit. If we do not address this primary problem soon with achievable results clearly in mind--before the overseas-money solution ends as it inevitably will--our economy, political situation, and society at large will experience instability such as we have never seen.

How can the Treasury deal with negative cash flow? The obvious solution to any businessperson is to increase revenue at the same time you reduce costs. And everyone who has been faced with this problem--as nearly everyone has in the past few years--knows, it's easier to reduce expenditures than to create revenue.

The Treasury's proposal takes a stab at increasing revenue, although not the quick, short-term revenue it needs. It does not appear to be balanced with a consistent program of reducing costs. Thus, I find it impossible to support the Treasury's current tax reform proposal because I see no real evidence--or thoughtfulness--on what the desired results from the proposed changes might be.

Senator DIXON. Then, at least from your perspective—and we thank you for your excellent statement—you feel that, on balance, one should not proceed at all along the lines that have been suggested in either the Treasury plan, Bradley-Gephardt, or Kemp-Kasten. Is that a fair characterization of what you are telling us?

Ms. SMITH. I think that as the plans are stated now, Senator, there is a need for reform in the tax system to simplify it. I probably have a bias on how we go about simplifying.

We put in, supposedly, a reform on the accounting for business expenses of automobiles. It is a nightmare. It is a nightmare reform. Better to have just said all businesses have to report 20 percent of an automobile's cost as personal income to the person receiving that benefit. It would have been easier than the way we "simplified" it.

Senator DIXON. Yes.

Ms. SMITH. So I think that the approach that is being taken is convoluted, and I don't think it necessarily treats companies equally, and I don't know whether you can be equal and equitable, too. I have a problem with all three proposals, and I think that we have a problem in this country—as you have spoken, too, about it—a deficit of major proportions, and the Treasury has to look at solving that problem.

Senator DIXON. I think it comes through clearly in this hearing that most of you have difficulties with a great many things that these plans contemplate—doing away with ACRS or investment tax credits, things of that character—and I guess it is clear to all of us that what is happening here is that when Treasury, on the one hand, or Bradley-Gephardt or Kemp-Kasten talks about simplification and reduces all those categories into three, let us say, that they have an immense revenue shortfall there. I have not done the math on it, but I am sure that is the case.

And so they go out here to all these other things, the entertainment expenses Mr. Kolb talked about, the deduction of the automobile for business purposes that you have just alluded to, the accelerated depreciation allowance, the incentive tax credits, and a variety of these other things, and they do away with them to make up that revenue shortfall, don't they?

Ms. SMITH. It appears so.

Senator DIXON. And so then I guess the question is, what is the best thing for the country? That is one of the issues here, I suppose.

I guess you folk are saying to us, "Look, this is certainly not going to be good for small businesses." Is that a fair characterization of it?

Ms. SMITH. I think so.

You know, you have talked about a tax amnesty bill. That raises short-term revenue that is needed to absorb this deficit. There are other ways to address that, too, if that is the problem that you are trying to attack. There is a minimum tax that could be placed on corporations so that the General Electrics or the Ford Motors or the Chryslers that are making what you perceive as excessive profits and not paying a fair corporate tax can pay a fair corporate tax, and I think that that could be done simply.

There is a surtax. If a surtax were put in for 2 years or 3 years—something that businesses know how to deal with and know what the range is that you are talking about, so that we can take it into consideration in our planning.

I think Mr. Brandzel can speak more of what some of the capital gains tax reforms are going to do to investors who normally invest in small businesses better than I can, because just of the uncertainty and how you can structure an investment at this point in time. Nobody even knows because we don't know what is going to be the tax on the future.

I think that there are other ways to raise revenue to address the problems that this country is having. I think we can take a longer look at reforming the system—which does need reform—but I don't think we just do a very quick stopgap kind of thing to appease maybe constituencies in other sectors of society today.

Senator DIXON. Mr. Brandzel, your name has been brought up in this discussion. What do you have to say in defense of your views?

Mr. BRANDZEL. Let me just point out one thing, and it may be something that has been alluded to before.

Senator DIXON. Could we have your name and address for the record, Mr. Brandzel?

Mr. BRANDZEL. I will send someone up with a dossier. It is on my letterhead.

Senator DIXON. Very good.

Mr. BRANDZEL. Let me point out one thing that has not been mentioned, which is the fact that you are looking at an Internal Revenue Code that has come through from evolution since 1913. Most of the changes that have taken place have some reasons, some economic reasons, some social reasons.

Specifically as to the capital gain, there is a reason for a differential between capital gains taxes and taxes on ordinary income because of the risk taking that is needed to generate capital infusion into the economy.

If we take away that incentive, we are severely going to inhibit the willingness of individuals—small businesses, in particular—to make that needed expenditure. I think, as Mr. Kolb pointed out, the thing that you get is a ripple effect.

It is not only the small business deciding not to buy that one additional piece of equipment; it is the effect on the supplier of that equipment; it is the effect on his suppliers, the people that provide the steel, the stainless steel in Mr. Kolb's case, the people that provide the nuts and bolts that go into that particular piece of equipment.

There are reasons for most of the provisions of the Internal Revenue code. Yes, it is complicated, but all three of the proposals make one sweeping-broom approach to the problem, and it is not that simple. It took us a long time to get here from 1913, with a lot of reasons for doing a lot of the things that we did.

What this does is very conveniently get rid of all the reasons. It comes up with, in the case of the Treasury, a decision by, I believe, the economists in the Treasury to decide that any business decisions should be made solely upon the effects of business and not consider whether you are going to pay a capital gains tax or any other type of tax.

That again is fine for a company like General Motors, but Mr. Kolb's company and some of the other people you have heard from have to take those factors into consideration. They do not have the capital to deal with, at their beck and call, in order to go out and get additional equipment or stock up on inventories or make expenditures of $25 to entertain a client without realizing there is going to be some incentive or some benefit for them to do that.

Senator DIXON. If I may interrupt, do you share what I think is coming through in some of this testimony—it has certainly been clear in what Ms. Smith said—a feeling that any of these contemplated plans will hurt the little businessman and won't bother the big businessman much?

I almost get the impression that there may even be a suggestion here that it is a good break for the big corporate entities, that they will save a lot of taxes, but small business will pay more. Is that a feeling you get?

Mr. BRANDZEL. That may be an oversimplification, also, but I think, in general, if you would ask for a yes or no, I would respond yes to that question. I think that when you look at the effect of these proposals on small business, they are devastating. The small businessman cannot deal with these sweeping proposals.

Senator DIXON. But a big businessman could? General Motors could? General Electric could? Chrysler?

Mr. BRANDZEL. A lot better. Obviously, it is going to have some effect on them, but they can deal with it a lot better, and their base of capital, their resources, their ability to maneuver, much better than the small businessperson. The small businessperson is very limited in those areas.

Senator DIXON. Do you actually think it would increase taxes for small, individual businesses? Somebody said that along here. Was it in this group?

Mr. BRANDZEL. Oh, absolutely. The lowering of the overall maximum rate of 33 percent is going to hurt small business.

Senator DIXON. Because it is now 26.75 percent or something?

Mr. BRANDZEL. Right. The overall surtax rate, I think, is 263/4, whatever that rate is. Some small businesses would have a mere $100,000 of taxable income. Their effective rate of tax is jumping 7 percentage points just by this inserting of a flat tax.

The effect to that small business—to Mr. Kolb's business, to Ms. Smith's business—is rather large as compared—and I don't want to keep on picking on General Motors—but $7,000 to General Motors or GE is the proverbial drop in the bucket.

Senator DIXON. Well, let me be the devil's advocate just for a moment with the three of you, because, you know, tax simplification is before the House, right? You know, the Congress has it. I suppose the truth is—and there are different opinions about this—I suspect that not much will happen this year. There will be a lot of hearings in House Ways and Means and Senate Finance, but I don't really think much will happen this year, although some are suggesting maybe it will.

But just for the purposes of discussing what might come down in the end, let's say—and I guess the polls do say—that a majority of Americans favor tax simplification, what, 2 to 1? I am told that 64 percent think we ought to have tax simplification. All right, so we start with that. I guess, then, the Congress will eventually say—and we have a popular President, and he said he wants to do this—

so if it comes down to discussing tax simplification, what would people out there in the business community say?

I have heard what Ms. Smith said. She said a minimum tax. Tax amnesty, of course, which is a one-shot deal but not bad, I think, as a sponsor of the idea. But what would be some of the things? For instance, there are all these different things—interest deductions, tax incentives, capital gains, ACRS—I am skipping a lot of them—entertainment deductions.

Mr. **BRANDZEL**. ITC.

Senator **DIXON**. A whole slew of them. You know, what do you do? I presume you cannot cut it down to two or three simplified categories and not drop some of these things, or tinker with them, or cap them, or something.

Mr. **BRANDZEL**. Well, I think the problem that we are having with all the bills is they are revenue neutral. If you start out with the proposition that they are revenue neutral, you immediately create all these problems because in order to make them revenue neutral and to follow with the administration's thought that we are not going to increase taxes, we must take away deductions.

As Ms. Smith pointed out, there are only a couple of ways to balance the budget. Either you increase revenues, or you cut costs, or some combination of both.

In all these bills, we are making no move, in effect, to increase income. We are revenue neutral; we are lowering the rate; therefore, we must create additional funds for the Treasury, and the only way to do that is to cut down on some of the tax costs.

These bills are not tax simplification bills. They are all misnomers. None of the proposals we have had over the last couple of years have been tax simplifications.

You have to look at each of the proposals you want to deal with. ACRS was, when enacted, tax simplification. If you looked at what ACRS was attempting to do, it was trying to get away from questions of what the useful life of this particular building was going to be.

Senator **DIXON**. I would agree with that. There would be a lot of people who would argue that probably we maybe——

Mr. **BRANDZEL**. Went too far.

Senator **DIXON**. I want to be the devil's advocate again and argue that we gave business a good break there, that the useful life is a good deal longer than what we provided by law, and of course, that was the understanding at the time; let's be frank about it. Isn't that true?

Mr. **BRANDZEL**. Absolutely.

Senator **DIXON**. So I guess it is a simplification, that is true.

Mr. **BRANDZEL**. But that was simplification, and what is being proposed now—in the Treasury, especially—is not simplification.

Senator **DIXON**. Yes.

Mr. **BRANDZEL**. It is the complete antithesis of simplification.

If you want to deal with something that is already simplified, and you want to change the years, as has been done recently, that is one factor. But all-encompassing proposals as we are dealing with here fail to take into consideration—these bills are intended to bring equality, but I don't think we can get to equality when we are talking about small business and General Motors. That is not going to happen. You therefore must look at each provision and see what is going to happen.

What is being done here, especially in Treasury, with the decision that you want to have everything based on an economic decision as opposed to a tax decision, is you clean everything out and you get it down to—forget that there are three layers of taxation. In fact, there is a flat tax and everything else is removed, and that is how you are going to simplify it. I submit to you that that does not simplify anything.

Senator DIXON. Well, but if I may interrupt, I guess I ask the obvious question now. If you are not happy—again, I am the devil's advocate—if you are not happy with all the eliminations of these deduction opportunities, let's generically say, to make it revenue neutral—and already we have a revenue shortfall; you understand that—we would have to do even more to bring in more revenue, and that would make you unhappier still, would it not, Mr. Brandzel? Does that make any sense to you?

Mr. BRANDZEL. Well, let me not speak for my firm. As a taxpayer, it may make me unhappy, but that may be a necessary cost of doing business by having to increase taxes.

Senator DIXON. You mean you would have to increase the number of categories, or you would have to increase the percentages in those categories to yield the necessary revenue?

Mr. BRANDZEL. Yes.

Senator DIXON. That is the simplified answer, is it not?

Mr. BRANDZEL. Yes.

Mr. KOLB. I don't know if that is the only conclusion you can arrive at. Costs can be cut. It seems to me, in the past, every time additional revenue has been raised, Congress has found an additional way to spend that revenue.

Senator DIXON. Yes; I am not quarreling with that, and I hear very clearly what you are saying about doing something about the budget deficits, and we are going to do that, and I think that will be the first order of business, actually, rather than the exercise we are engaged in here today. But I just wanted to clarify the record.

Now I would like to call on Cynthia L. Straus, president of Chem-Plate Industries, Inc., and board member, Chicago Metal Finishers Institute; and Robert Atherton, chairman of Raco Industries Corp.

We thank you both for being so patient.

Ms. Straus, do you have a written statement?

Ms. STRAUS. I am sorry, I do not, Senator.

Senator DIXON. That is quite all right.

Ms. STRAUS. I was called Friday afternoon, and I did not get the packet until Saturday.

Senator DIXON. You were a witness at the hearing that Mr. Stockman participated in last week?

Ms. STRAUS. Yes, I was.

Senator DIXON. I am sorry I missed your testimony.

Do you want to make a short statement? Then Mr. Atherton has a short written statement, and then I will question you both. How is that?

Ms. STRAUS. OK.

STATEMENT OF CYNTHIA L. STRAUS, PRESIDENT, CHEM-PLATE INDUSTRIES, INC., AND BOARD MEMBER OF CHICAGO METAL FINISHERS INSTITUTE

Ms. **Straus**. Senator Dixon, I would like to say that I am not quite as calm and polite as the other witnesses have been this morning in regard to these proposals. I feel, frankly, quite outraged with the Treasury Department's arrogant attitude toward business and with the general attitude of the public toward business.

For a long time, business, big and small, has been the bad guy and the people who take all the money and keep it for themselves, and in the past few years, with the unrest in our economy, people have finally woken up to the fact that small business, in particular, has been the innovators and the creators of the jobs that people hold in this country, and now suddenly they are very interested in what our opinions are and how we feel about many different subjects.

My industry, the metal finishing industry, has spent many hours and thousands and thousands of dollars testifying to the Congress on various subjects. I feel a little cynical coming here this morning. Although it is not directed at you personally, I do feel cynical about Congress' attitude toward what we have to say.

I feel we have given some very good advice over the past years which could have avoided some of this deficit that has been created by Congress, and it has continually, repeatedly, been ignored on many areas. Therefore, you come back to us with what you call a tax reform act which is supposed to be neutral and is not supposed to be a tax increase to business.

I looked at all three of these proposals in light of my own business. I have a small electroplating company. The metal finishing industry, by and large, is made up of small businesses that are under $2 million in sales and under 20 employees. My firm is considered very large in comparison to most of the other electroplating types of firms.

We started our business 6 years ago with a $60,000 SBA-guaranteed loan and $20,000 of our own capital, and we worked very hard to bring in all the latest technology, to put in the newest equipment possible, to do things more efficiently at a lower price. As a result, we were able to grow very fast, and we now have a $4 million a year company.

This past year, we made a decision to make a capital investment of over $1 million into new equipment. Without the ITC and the depreciation generated from this investment, we would not have been able to make the investment. It would have been impossible.

Most people look at the net profit of a company and say, That's their money; they're being selfish with their money, and they really should be paying more taxes or supporting more of the bill, when in actual fact, net profit is before you pay off loans. Net profit is a totally different number from cash flow. And depreciation and investment tax credits are what have helped our business to grow and expand the way that it has over the past 6 years.

I think that in considering these proposals, one must keep in mind that cash flow is what we are concerned with when you keep a company operating and you make a company grow and expand.

I look at these proposals, and I consider them a back-door approach to raising taxes. The Lieutenant Governor referred to the Small Business Committee Advisory Commission for the State of Illinois to Governor Thompson. I serve on the Small Manufacturers Action Council for the Illinois Manufacturers Association. There are two members of our council that serve on this advisory board to the Governor.

We discuss at great length at every meeting we have the problems that we face with business. Many of us go to the State Legislatures and to the Senate to testify, and we find that the ear is often turned deaf for politically expedient reasons. It has been that way in the State of Illinois.

All in all, though, there is no one who feels that there should be a tax increase to business. We feel that it is time for the Federal Government to do the same thing that business has done, and that is to become more efficient, more quality conscious, and more competitive with its counterparts.

None of us would be against—or we would volunteer happily to come to any one of your departments and show you how it can be run more efficiently, and it can be done at the Federal Government level, and it is time that you clean your own house up.

Just the automobile expense situation caused such outrage that everybody, to a man, there at the meeting said their accountant's attitude was that they should lie.

Senator DIXON. May I interrupt at that point? What do you think of the latest Treasury regulations in respect to automobile depreciation allowances? I am told that that does not seem to be satisfactory to business people generally, either. Would that be your feeling about it?

Ms. STRAUS. Yes, it is. The small businessman, in particular, needs an automobile to get to work and to entertain customers and to take customers around. I use my automobile all the time, and it is a legitimate business expense. I have no problem paying taxes on 20 percent of the expense. I have no problem with that at all, and I think that certainly would be a lot simpler than what they are talking about today.

Senator DIXON. Well, for what it is worth, I agree with you. We hope we are going to be able to make some changes in that.

Ms. STRAUS. I think that not only businessmen should do that but everybody in the country should do that. Anybody who drives any kind of a vehicle should declare part of that vehicle as income if that is what we have to do. If we want to be fair and equitable, let's be fair and equitable and not divide the different groups of people as to who should do this and who should not.

Senator DIXON. Would you mind if I take Mr. Atherton's statement, which I think is a short one, and then we will ask you both a couple of questions if you don't mind.

Ms. STRAUS. All right.

Senator DIXON. Mr. Atherton.

STATEMENT OF ROBERT C. ATHERTON, CHAIRMAN, RACO INDUSTRIES CORP., ON BEHALF OF THE MACHINERY DEALERS NATIONAL ASSOCIATION

Mr. ATHERTON. Senator Dixon, ladies and gentlemen, I am Robert C. Atherton, chairman of Raco Industrial Corp. of Des Plaines, IL, a dealer in new and used metalworking machinery.

I am also a director and past president of the Machinery Dealers National Association and have been in the machine tool business for 35 years.

Our company is a small business firm. All the members of the Machinery Dealers National Association are small business firms. I would estimate that 90 percent of our sales of our firm and our members go to small business firms.

I feel that it is essential to our national interest to retain the investment tax credit on new and also used metalworking machinery and other capital goods and also retain the present 5-year depreciation schedule.

The tax reform bill of 1981 recognized the need to stimulate investment in capital goods and plant modernization, but the benefits were not felt by most industries due to the serious recession of 1982 and 1983.

The combination of the investment tax credit and depreciation provides the cash flow that manufacturers need to modernize with new and used machines. The present regulations allow a manufacturer to recoup approximately 20 to 25 percent of his investment in the first year. The present Treasury proposal allows only a 6 percent recovery the first year, discouraging capital investment and thus increase in our productivity.

Furthermore, technology is changing at an ever-accelerating rate, making increased investment vital to meet worldwide competition.

During the past 6 years, a substantial portion of U.S. heavy industry has been wiped out, in part due to the influx of imported products being produced by highly efficient plants overseas, usually with drastically lower labor costs.

Such critical Illinois industries as machine tools, construction machinery, farm machinery, the steel industry, the forging industry, and many others have been very severely impacted and many jobs permanently eliminated. Most of the surviving industries are still losing money and in a state of recession.

The machine tool industry is critical to our national defense because all products are made on machine tools or their derivations; and yet employment decreased from about 125,000 people in 1980 to 62,000 in 1984, and this industry, formerly a worldwide exporter, now is dominated by foreign imports in our own marketplace.

Our Nation and our State need strong viable heavy industry. The elimination of the investment tax credit and prolongation of depreciation will be another huge setback for our industries, already besieged by many problems.

Senator Dixon, we thank you for your efforts to get the administration to approve the National Security Petition requested by the machine tool industry. Also, we urge your support for the National Product Liability Act, necessary to establish a fair balance to the interests of all parties in product liability litigation. This has been another major handicap and major cost to the machine tool industry and to all industry.

On behalf of myself and the 450 member firms of the Machinery Dealers National Association, I must strongly urge that these tax incentives be retained to help save and strengthen our American industry.

Thank you very much for allowing me to appear here today, Senator.

[The prepared statement of Mr. Atherton follows:]

MDNA
MACHINERY
DEALERS
NATIONAL
ASSOCIATION
CHICAGO CHAPTER

March 1, 1985

Senator Alan Dixon
Senate Small Business Committee
HEARING AT DIRKSEN FEDERAL OFFICE BUILDING
Room 2525
219 South Dearborn St.
Chicago, Illinois

Senator Dixon, Ladies & Gentlemen:

I am Robert C. Atherton, Chairman of Raco Industrial Corporation of Des Plaines, Illinois a dealer in new and used metalworking machinery. I am also a Director and Past President of the Machinery Dealers National Association and have been in the machine tool industry 35 years.

I feel that it is essential to our national interest to retain the investment tax credit on new & used metalworking machinery and other capital goods and also the present 5 year depreciation schedule. The tax reform bill of 1981 recognized the need to stimulate investment in capital goods and plant modernization, but the benefits were not felt by most industries due to the recession of 1982 and 1983.

The combination of the Investment Tax Credit and depreciation provide the cash flow that manufacturers need to modernize with new and used machines. The present regulations allow a manufacturer to recoup 25% of his investment in the first year. The present treasury proposal allows only a 6% recovery the first year, discouraging capital investment, and thus increase in our productivity. Furthermore, technology is changing at an ever accelerating rate making increased investment vital to meet world wide competition.

During the past 6 years, a substantial portion of U.S. heavy industry has been wiped out, in part due to the influx of imported products being produced by highly efficient plants overseas, usually with drastically lower labor costs. Such critical Illinois industries as machine tools, construction machinery, farm machinery, the steel industry, the forging industry and many others have been very severely impacted and many jobs permanently eliminated. Most of the surviving industries are still losing money and in a state of recession.

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MDNA
MACHINERY DEALERS NATIONAL ASSOCIATION
CHICAGO CHAPTER

Page 2

Our nation and our state need strong viable heavy industry. The elimation of the investment tax credit and prolongation of depreciation will be another huge set back for our industries, already besieged by many problems.

Senator Dixon, we thank you for your efforts to get the administration to approve the National Security Petition requested by the Machine Tool Industry. Also, we urge your support for the National Product Liability Act, necessary to establish a fair balance to the interests of all parties in product liability litigation.

On behalf of myself and the 450 member firms of the Machinery Dealers National Association, I must strongly urge that these tax incentives be retained to help save and strengthen our American industry.

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Senator **Dixon**. Well, I want to thank both you and Ms. Straus for being so patient and waiting until the end like this.

I would like to ask if both of you would accommodate us by answering whatever questions we might send along by mail to you in writing at your leisure in the near future.

Mr. **Atherton**. I would be very honored.

Senator **Dixon**. We would appreciate that very much.

[Subsequent information was received and follows:]

Raco Industrial Corp.,
Des Plaines, IL, April 2, 1985.

Senator Lowell Weicker, Jr.,
Senator Alan J. Dixon,
Washington, DC.

Dear Senators Weicker and Dixon: Thank you for letter of March 18 requesting more information regarding my views on present tax proposals, and especially regarding changes in accelerated depreciation and the investment tax credit.

In response to your question, accelerated depreciation and investment tax credit favor capital intensive industries. These capital intensive industries have made possible our high level of American productivity, our high wage levels for workers, and our high standard of living.

Most, if not all of the heavily industrialized countries in the world with whom our industry must compete have similar tax incentives to promote the productivity of their industry.

The capital intensive industries such as steel, foundry, forging, automotive, construction equipment, ship building, machine tools, aircraft, farm implements and similar are the heart of our industrial strength and also our defense capability. These industries also generally afford the best paying jobs for our workers.

Even with our present tax incentives, many of our industries are struggling to survive and many have already been lost. Now is not the time to take away or reduce these incentives, so badly needed to stimulate and modernize our industry.

Admittedly, investment tax credit and accelerated depreciation favors capital intensive industries over labor intensive or inventory intensive industries.

This is justified because the capital intensive industries provide better products at lower cost to the inventory intensive industries and to the consumer.

The capital intensive industries provide our labor intensive industries with the tools and equipment to be more efficient and productive and to compete with the very low cost labor intensive industries overseas, thus preserving our American jobs and enabling higher wage scales.

It is most important to our U.S. economy and to our defense that our industry be modernized and strengthened and expanded.

Continuation of the present investment tax credit and also accelerated depreciation is most important to attain these goals.

It would further help small business if the present $125,000 ceiling on investment tax credit on used machinery could be increased to $250,000 or more. Usually small manufacturing firms modernize with newer model used machines and they do not get the same unlimited investment tax credit benefits as big firms which usually modernize with brand new machinery, much of which now comes from overseas.

Thank you for this chance to provide additional information and please let me know how I can be of further service.

Sincerely,

R. C. Atherton, *Chairman.*

Note: The above comments are presented on behalf of my firm which sells new and used machinery and also on behalf of the 450 member firms of the Machinery Dealers National Association.

Senator **Dixon**. Do I understand that you feel that the investment tax credit and accelerated depreciation are biased in favor of capital-intensive industries rather than labor-intensive industries, Mr. Atherton?

Mr. **Atherton**. It does favor capital-intensive industries.

Senator **Dixon**. I would like to elaborate upon that with you by some written questions at a later date, if I may.

Mr. ATHERTON. Yes, sir, please.

Senator DIXON. Ms. Straus, I take it from what you have told us that it is your very strong feeling that these deductions that you now are permitted to employ in your business are valuable tools for your business to be a success, and that an alteration of the Tax Code such as suggested either by Treasury, Bradley-Gephardt, or Kemp-Kasten would be very damaging economically to you and your business.

Ms. STRAUS. Yes.

Senator DIXON. Is that your view, too, Mr. Atherton?

Mr. ATHERTON. I think so. Yes, sir.

Ms. STRAUS. I would like to say that as he was mentioning that in the industry, the actual manufacturing area, they have suffered a great deal, we all have suffered a great deal over the past years because of the competition that we are facing, not only from importers but for funds to make capital expansion possible. There is a very great need for all of the manufacturing companies to modernize their plants and equipments, not only to be more efficient but to meet new government regulations that have been coming through by the bushel-load.

These kinds of changes would make it very difficult for us to continue investing and modernizing our plants, not just for myself but for many of the people on the Small Manufacturers Action Council.

Senator DIXON. So any tax simplification program that would do violence to these particular devices that have been helpful to you and your business, you think, would be harmful generally to small business?

Ms. STRAUS. Yes, I do. I think it also puts the cart before the horse. As Sheila was saying, whenever you have a revenue shortfall, you must first look at how you cut costs, and I think that that is where the time should be spent, and that you go to the businesspeople who are professionals at cutting costs and being more efficient and work on that first, and then we can work on tax reform.

Senator DIXON. Well, I thank you both very much, and we are going to send you some questions, if you don't mind, and we would appreciate your answering all of these.

Everything that has transpired here today will be part of the official record in connection with what ultimately is determined by the Congress regarding what we have so often referred to today as tax simplification, and we appreciate the messages that you have brought to us.

This was an official meeting of the Small Business Committee of the U.S. Senate sitting in the city of Chicago on this date pursuant to the call of Lowell Weicker, chairman, Dale Bumpers, ranking member, and I declare this meeting adjourned.

[Whereupon, at 12:08 p.m., the committee recessed, to reconvene at the call of the Chair.]

APPENDIX

INDEPENDENT BUSINESS ASSOCIATION
OF ILLINOIS

IBAIL

WRITTEN TESTIMONY
ON
TAX REFORM
March 4, 1985

The Independent Business Association of Illinois (IBAIL) represents members with an average employment of 10-20 per firm. We believe that this membership reflects the small business community in the State of Illinois. Given that premise we strongly protest the proposed Treasury Department's tax plan which would result in a flat tax of 33% on all corporations. The net effect of implementing this proposal would be to provide an incentive to be a large corporation, but a strong disincentive to start or expand a small corporation, given the punitive effect of the flat tax rate during the early years of low profitability.

The availability of capital has historically been a problem for small business. Getting the capital necessary to start a business is problematical for emerging entrepreneurs and getting the capital to grow - especially long-term, low-cost capital -- is problematical even for experienced entrepreneurs. Further decreasing the pool of capital available to these people -- the inevitable effect of reducing their profitability -- will only put more obstacles in the path of small business. By increasing the tax liability of a large percentage of small businesses, the

8565 W. Dempster · Niles, IL 60648 · 312/692-7306

Federal Government will inject substantial negative influences on the decision to form or expand small businesses. Available capital for small businesses also depends on tax incentives (e.g., R&D tax incentives, investment tax incentives, job training tax incentives), which permit a firm to retain a portion of its earnings which, in turn, can be used for expansion, investment in other businesses, and/or research and development (let us not forget the current emphasis on international competitiveness which will be hurt in the process of simplifying the tax policy). Furthermore, it is questionable that the risk capital community will see fit to invest in companies that cannot pay a rate of return greater than other types of investments.

All in all, the proposed tax reform will really hurt small business which is touted as providing revenues, income and jobs in the American economy. And it will hurt the ability of small firms to innovate (i.e., be competitive in the world's economy). We strongly oppose this measure. And, we provide a closing thought of the President's.

> "Tax policies that sustain the cash flow of small firms will continue to be a major goal of this Administration."

The State of Small Business: A Report of the President, Washington, D.C., U.S. Government Printing Office, 1984, p/ viii.

Paper Prepared by:

Marcia Rorke
Mohawk Research Corp.
Lake Forest, IL.

NFIB® National Federation
of Independent Business

The Guardian of Small Business

February 14, 1985

Honorable Lowell Weicker, Jr.
United States Senate
Washington, D.C. 20510

Dear Lowell:

Do you want to raise taxes 75% to 100% for three-quarters of the corporations in your states? If your answer is no, please read this letter.

Both Treasury and Bradley-Gephardt propose more than a 100% tax increase for over 50% of your smallest corporate constituents. Under either of these proposals, three-quarters of your corporate taxpayers will have their taxes raised over 75%.

Our current tax structure places serious constraints on the earnings and growth capabilities of many small businesses, in part because many of the tax incentives utilized by capital-intensive industries result in a shift in tax burdens to small firms within industries that are labor and inventory intensive. Due to their capitalization and generally lower probability of attracting outside investors, small corporations have found targeted tax incentives to be largely ineffective in providing any tax relief. Instead they have relied on retained earnings produced by the graduated corporate rate schedule available to corporations with less than $100,000 in taxable income.

Several so-called tax simplification proposals, chief among them the Treasury proposal and the Bradley-Gephardt Fair Tax Act, would eliminate the graduated corporate rate schedule and replace it with a flat corporate tax of 33% or 30% respectively. The following chart illustrates how this change might impact small firms and how their tax burdens might increase. At the same time, these proposals provide large corporations with significant reductions in tax rates.

Treasury Reform Proposal

Taxable Income	Existing Tax Schedule	Proposed Tax Schedule	Net Increase (Reduction)
0-$25K	15%	33%	120%
25K-50K	18%	33%	83%
50K-75K	30%	33%	10%
75K-100K	40%	33%	(17.5)%
100K & over	46%	33%	(28.3)%

Federal Legislative Office
600 Maryland Avenue, SW
Washington, DC 20024
202-554-9000

Bradley-Gephardt Proposal

Taxable Income	Existing Tax Schedule	Proposed Tax Schedule	Net Increase (Reduction)
0-$25K	15%	30%	100%
25K-50K	18%	30%	67%
50K-75K	30%	30%	-0-
75K-100K	40%	30%	(25)%
100K & over	46%	30%	(35)%

While there is no precise way to translate the gross receipt tables of IRS Statistics of Income into the five taxable income categories listed above, it is virtually certain that firms with $500,000 or less in gross receipts do not have taxable income over $75,000. Almost all of the firms with gross receipts under $500,000 will therefore be affected by the tax increases in the graduation schedules, especially those firms in the lowest three taxable income brackets. According to the IRS tables, 75% of all small corporations, or three out of four of your small corporate constituents, will fall into this category and see their taxes increased under either reform plan.

Congress enacted the graduation schedule in 1975 to provide an incentive for firms to grow and to create jobs. The explosive growth in jobs and productivity among smaller businesses over the last 5 years can indeed be attributed, at least in part, to this reduction in corporate tax rates, which has provided real incentive for new investment and increased productivity.

Before sponsoring or voting for a proposal to eliminate the graduated corporate tax rate, review the above chart and discuss the changes with owners of small corporations in your state. It should become quickly apparent how a flat corporate tax rate would increase the taxes paid by these small firms.

NFIB will vigorously oppose any tax simplification proposal that increases taxes for smaller corporations by eliminating the graduated corporate rate. We do not believe that 75% to 120% tax increases for nearly three-quarters of all the small corporations in the United States is any way to reform the tax code.

I urge you to support us in this effort by refusing to endorse either Bradley-Gephardt or the Treasury proposal until they drop this regressive feature. I would very much like to hear from you on this important small business issue.

Sincerely,

John

John J. Motley III
Director of Federal Legislation

Akl/1687D

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
the national voice of wholesale distribution

1725 K Street, N.W.
Washington, D.C. 20006

202/872-0885

Nicholas E. Calio
Vice President - Government Relations
Direct Dial 202/728-7660

February 15, 1985

The Honorable Lowell Weicker, Jr.
Hart Senate Bldg Room 303
United States Senate
Washington DC 20510

Dear Senator Weicker:

The National Association of Wholesaler-Distributors and its 45,000 member companies are extremely concerned about the potential impact of the Department of Treasury's corporate tax rate proposal on small business. A flat corporate tax rate of 33 percent as proposed by the Department of Treasury would significantly raise the taxes of most wholesaler-distributors and other incorporated small businesses--the very enterprises that are so widely credited with creating the vast majority of new jobs in our economy over the last ten years.

The impact of a flat corporate tax rate of 33 percent would be particularly pronounced in the wholesale distribution industry and the retail industry. Both sectors are subject to high effective tax rates overall -- approximately 35 percent for wholesaler-distributors according to the Joint Committee on Taxation's most recent annual effective tax rate study.

However, as the enclosed memorandum and graph prepared by NAW from data reported in Statistics of Business Income (1981) indicate, approximately 94 percent of reporting wholesale distribution and retail corporations fall below the 33 percent tax rate based upon their level of earnings under current law. (Companies in both industries generally have earnings of 3 percent or less on sales. Hence, approximately $5,200,000 in sales are required to reach a 33 percent effective tax rate.)

The graph is not a perfect measure of the impact of the Treasury proposal. Nonetheless, it suggests a serious problem which merits serious examination.

Congress recognized in 1975 that graduated corporate tax rates would provide capital expansion funds not otherwise available to small businesses; eliminating them now will deprive the nation's small businesses of the ability to retain earnings and, thus, to grow.

Finally, conversion to S Corporation status will not resolve the difficulties created by eliminating graduated corporate rates. To take just one example, the income of an S Corporation is taxed to its shareholders whether or not the cash is actually distributed to them. Hence, S Corporation status is inappropriate where a company's profits are required to retire a long-term debt or to finance capital expansion.

The graduated rate issue must be dealt with as tax reform works its way through Congress. The basic thrust of the Treasury proposal, particularly the overall reduction in the corporate tax rate, is positive. Resolution of the graduated rate problem would make it much more positive.

We would appreciate your views on this issue.

Sincerely,

Nicholas E Calio

Nicholas E. Calio
Vice President -
Government Relations

Enclosure

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
1725 K Street, N.W.
Washington, D.C. 20006
the national voice of wholesale distribution
202/872-0885

IMPACT OF FLAT 33 PERCENT CORPORATE TAX RATE ON SMALL WHOLESALE DISTRIBUTION AND RETAIL CORPORATIONS

The attached graph -- "Sales/Effective Tax Rates of Wholesale Distribution and Retail Corporations Reporting to IRS" -- was prepared from Statistics of Income--1981, Corporation Income Tax Returns (hereafter Statistics of Income). It is intended to demonstrate the potential impact of a flat corporate tax rate of 33 percent on small business, specifically those in wholesale distribution and retail trade.*

The graph demonstrates the potential impact by charting the effective tax rates of corporations** in these industrial classifications against sales volume, and then, against the number of reporting corporations which, under current law, would fall below and above the proposed flat 33 percent corporate tax rate.

The effective tax rate determinations were made by assuming profits of 3 percent on sales -- a profit margin which is in fact accurate, on average, for both wholesale distribution and retail corporations. The amount of tax payments due under the rate structure in current law at various sales and profits levels were then determined and divided into earnings to determine effective rates.

The graph illustrates that a wholesale distribution or retail firm must have over $5,000,000 in sales ($5,161,000 by actual count) to be taxed at an effective rate of 33 percent under current law.

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*Statistics of Income considers the wholesale distribution and retail sectors together.

**Well over 90 percent of the National Association of Wholesaler-Distributors membership are corporations.

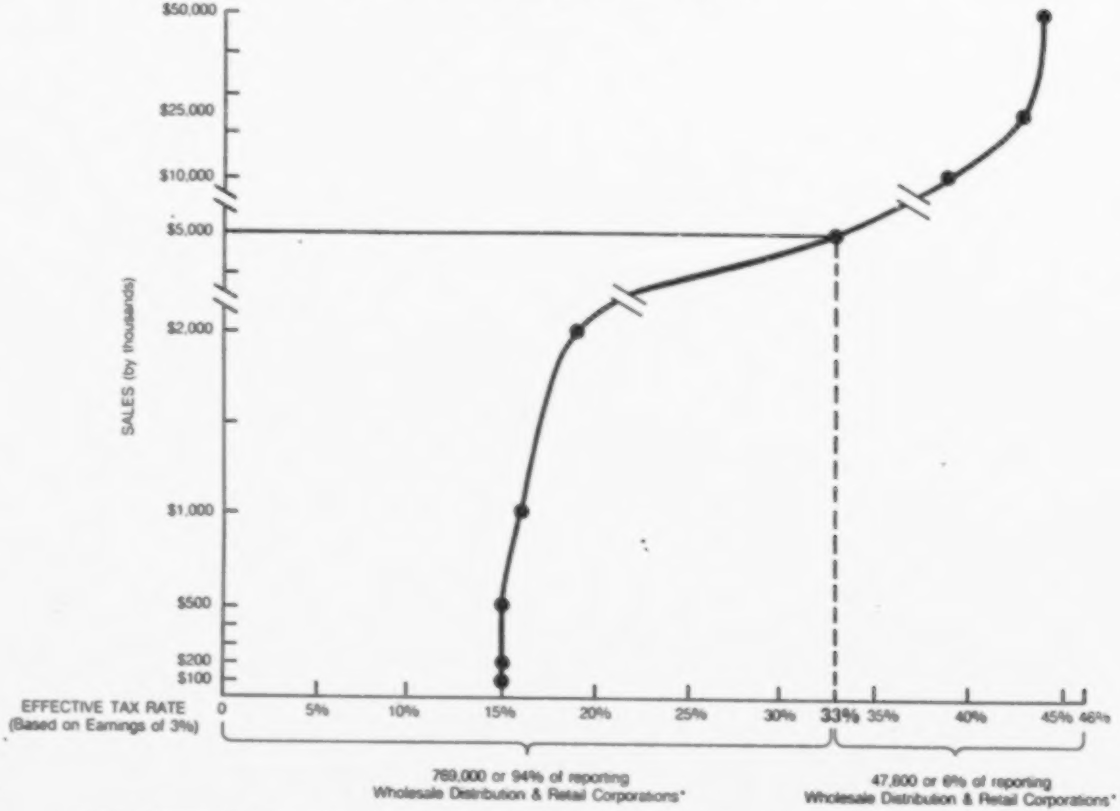
Data from Table 7 of Statistics of Income, which breaks down the returns of active corporations by Industrial Division and by Size of Business Receipts, is plotted on the graph directly below the horizontal effective tax rate line.

That data indicates that fully 94 percent (approximately 769,000 out of 816,000) reporting wholesale distribution and retail corporations fall below the $5,000,000 sales and, consequently, the 33 percent effective tax rate benchmark.

On the other hand, only 6 percent (approximately 48,000 out of 816,000) reporting wholesale distribution and retail corporations surpass the benchmarks.

In short, the graph, while not a perfect measure, strongly suggests that the failure to provide a graduated corporate rate structure will raise taxes for the overwhelming majority of wholesaler-distributors and retailers.

SALES/EFFECTIVE TAX RATES OF WHOLESALE DISTRIBUTION AND RETAIL CORPORATIONS REPORTING TO IRS



*Statistics of Income—1981, Corporation Income Tax Returns, Table 7, reports 816,800 active corporations filing returns in the Wholesale and Retail Trade Division.

National Retail Merchants Association

NRMA

TELEX · INT'L 220 · 883 · TAUR
TWX · DOMESTIC 710 · 581 · 5380 TPNYK
ATTN NRMA

1000 Connecticut Avenue, N.W.
Washington, D.C. 20036
202/223-8250

bcc: Robert J. Dotchin ✓

February 12, 1985

Honorable Lowell Weicker, Jr.
Chairman
Committee on Small Business
United States Senate
Washington, D.C. 20510

RE: Tax Simplification Field Hearings

Dear Mr. Chairman:

I am writing on behalf of the National Retail Merchants Association to provide testimony on the various tax simplication proposals on which your committee will be holding field hearings. We request that this letter be included as part of the official record of those hearings.

By way of background, NRMA is the nation's largest trade association for the general merchandise retail industry. Our members operate 40,000 leading department, chain, independent and specialty stores in all 50 states. Their annual sales exceed $150 billion and they employ more than 3 million workers. The vast majority of NRMA's members are small, independent retailers whose annual sales are less than $1 million.

Tax simplification and reform is an issue of the highest priority to general merchandise retailing and is of acute concern to independent retailers.

Last November, then-Secretary of Treasury Regan released the Department's Report on Fundamental Tax Simplication and Reform. This report, which proposes a broad-based income tax to lower marginal tax rates for individuals and corporations, and simplifies the Internal Revenue Code, appears to be a more comprehensive effort than other modified flat-tax proposals which have been introduced this Congress. As such, it has generally been well received by much of the general merchandise retail industry because it recognizes and attempts to alleviate many of the complexities and inequities presently inherent in the U.S. tax code. However, while the Treasury proposal would assist many sizable retailers who have traditionally paid taxes at or close to the highest effective tax rates, one of its elements — the elimination of the graduated corporate tax rate — would have a devastating effect on the nation's smaller companies.

Under the Treasury proposal, as well as under several of the other modified flat tax proposals, the graduated corporate tax rate structure would be repealed or

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-Sasser –
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significantly modified. For small businesses, including small, retailers, the elimination of the graduated corporate tax rate would dramatically increase their effective tax rates and reduce essential capital available for continued operation and growth. In general, small businesses with less than $150,000 of taxable income would face substantial increases in tax liability with the elimination of the graduated corporate tax rates.

The following chart compares the changes in corporate tax liability under the Treasury Department proposal with current tax law.

CHANGES IN CORPORATE TAX LIABILITY
UNDER THE TREASURY PROPOSAL*

Taxable Income	Tax under Current Law	Tax Under Treasury Proposal	Net Tax Increase (Decrease)	Percentage Change
$10,000	$1,500	$3,300	$1,800	120%
$25,000	$3,750	$8,250	$4,500	120%
$40,000	$6,450	$13,200	$6,750	105%
$50,000	$8,250	$16,500	$8,250	100%
$65,000	$12,750	$21,450	$8,700	68%
$75,000	$15,750	$24,750	$9,000	57%
$100,000	$25,750	$33,000	$7,250	28%
$125,000	$37,250	$41,250	$4,000	11%
$150,000	$48,750	$49,500	$750	2%
$200,000	$71,750	$66,000	($5,750)	(8%)

* This table assumes, for purposes of illustration, that a corporation's taxable income would not be increased or decreased by the Treasury proposal.

For a small firm with taxable income of $50,000 or less, repealing the graduated corporate tax rates would result in at least a 100 percent increase in taxes. Significant but less severe tax increases result when a firm's taxable income ranges from $50,000 to $150,000.

Since many small businesses now pay at rates below 33 percent, the maximum corporate rate set forth in the Treasury Department's proposal, we hope that this Committee and the tax-writing Committees in the House and Senate will look very closely at this aspect of any bill.

Independent retail store owners use retained earnings as an important source of operating and expansion capital. As such, the problem of access to capital and capital accumulation is one of the most difficult barriers small retailers face in starting and expanding their business. Like other small businessmen, independent retailers do not have the ease of access to commercial loans enjoyed by larger corporations, and when they do negotiate loans, they pay interest rates substantially above the prime rate.

As this Committee is well aware, small businesses account for about 40 percent of the gross national product and two-thirds of all new employment. This entrepreneurial spirit needs to be encouraged, not stifled by Federal tax policies which run counter to the interests of the nation's small businesses. If the graduated tax is repealed, thereby forcing many small businesses to pay higher taxes, it will have a serious detrimental effect, not only on the small business, but on the economic growth of the country as a whole. For these reasons, NRMA strongly opposes any efforts to repeal the graduated corporate tax rates.

Should there by any questions from Committee members or staff, please contact me or Tracy Mullin, NRMA Senior Vice President for Governmental Affairs, at 202/223-8250.

Thank you for the opportunity to again present NRMA's views to the Committee.

Sincerely,

James R Williams

James R. Williams
President

cc: Members of Senate Small Business Committee

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